Supreme Court, U.S.
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No. —— OFFICE OF THE CLERK

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1994

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JACK R. HAWKINS and CYNTHIA HAWKINS,
*Petitioners,*

v.

UNITED STATES OF AMERICA,
*Respondent.*

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**Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

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## PETITION FOR A WRIT OF CERTIORARI

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GREGORY R. SMITH
(Counsel of Record)
LAWRENCE M. STONE
ELLIOT BROWN
IRELL & MANELLA
1800 Avenue of the Stars
Suite 900
Los Angeles, CA 90067
(310) 277-1010

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## QUESTION PRESENTED

Whether a punitive damages award received in a personal injury suit is excludable from gross income as "any damages . . . received on account of personal injuries. . . ." 26 U.S.C. § 104(a)(2).

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## PETITION FOR A WRIT OF CERTIORARI

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Petitioners Jack R. Hawkins and Cynthia Hawkins respectfully pray that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Ninth Circuit in this matter.

## OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 30 F.3d 1077 (9th Cir. 1994), and is reprinted in the appendix hereto at 1a-21a. The decision of the district court is reported at 93-1 U.S. Tax Cas. (CCH) ¶ 50,208 (D. Ariz. 1993), and is reprinted in the appendix at 22a-24a.

## JURISDICTION

The Ninth Circuit issued its decision on July 19, 1994. A timely petition for rehearing and suggestion for rehearing en banc was denied on September 13, 1994.

This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

## STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. Section 61(a) of the Internal Revenue Code of 1986, 26 U.S.C. § 61(a), provides in relevant part:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.

2. Section 104(a) of the Internal Revenue Code, 26 U.S.C. § 104(a), provides in relevant part:

> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—
>
> . . . . .
>
> (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

3. Section 1.104-1(c) of the Treasury Regulations, 26 C.F.R. § 1.104-1(c), provides:

> Section 104(a)(2) [of the Internal Revenue Code] excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

## STATEMENT

This case raises the issue whether punitive damage awards received in a personal injury suit are excluded from federal income tax.

In 1978, Cynthia Hawkins, driving a car owned by herself and her husband and insured by Allstate Insurance Company, was involved in a serious automobile accident which demolished the Hawkinses' car. Allstate, acting in bad faith, failed to meet its obligations with respect to the replacement of the Hawkinses' car.

The Hawkinses sued Allstate in state court in Arizona and were awarded compensatory damages as well as punitive damages of $3.5 million, *see Hawkins v. Allstate Ins. Co.*, 733 P.2d 1073, 1077 (Ariz.), *cert. denied*, 484 U.S. 874 (1987), all of which were paid by Allstate in 1988.

On their 1988 federal income tax returns, the Hawkinses reported the punitive damages award (less attorneys' fees and costs) as taxable income. They subsequently filed an amended return asserting that the punitive damages were excludable from gross income as "damages received . . . on account of personal injuries . . . ," 26 U.S.C. 104(a)(2), and sought a refund. Petitioners' Appendix at 4a (hereinafter "Pet. App."). The Internal Revenue Service disallowed the refund. The Hawkinses then initiated this tax refund case in the United States District Court for the District of Arizona.

At trial, it was conceded by the government (and accepted by the district court and Ninth Circuit) that "the Hawkinses suffered 'personal injuries' as a result of Allstate's conduct . . . [and that therefore] the Hawkinses' *compensatory* damages are excludable 'damages received . . . on account of personal injury [sic].'" Pet. App. at 4a (emphasis in original). Hence, the sole issue was whether the Hawkinses' punitive damages, received in connection with the same "personal injury" tort claim that gave rise to the compensatory damages, were also excluded from gross income pursuant to Section 104(a)(2).

On cross-motions for summary judgment, the district court granted the Hawkinses' motion and denied the

United States's motion, concluding that the Hawkinses' punitive damages award was excluded from gross income under Section 104(a)(2). The district court cited to *United States v. Burke,* 112 S. Ct. 1867 (1992), and reasoned that because personal injury was the requisite for the award of punitive damages to the Hawkinses, the statutory exclusion from gross income of "any damages received . . . on account of personal injuries" included punitive as well as compensatory damages.

On appeal, a divided panel of the Ninth Circuit reversed and held that punitive damages received in a personal injury suit are not excludable from gross income pursuant to Section 104(a)(2). In so doing, the majority (Judges Goodwin and Ferguson), refused to follow an earlier Ninth Circuit panel, *Roemer* v. *Commissioner,* 716 F.2d 693 (9th Cir. 1983), rejected two almost unanimous en banc Tax Court decisions, *Miller v. Commissioner,* 93 T.C. 330 (1989) (15 to 2), *rev'd,* 914 F.2d 586 (4th Cir. 1990), and *Horton v. Commissioner,* 100 T.C. 93 (1993) (16 to 3), *aff'd* 33 F.2d 625 (6th Cir. 1994), and found that this Court's decision in *Burke,* 112 S. Ct. at 1872 (focusing, "for purposes of § 104(a)(2), on the nature of the claim underlying [the taxpayers'] damages award"), had no application. The majority acknowledged that reasonable minds could differ, noting that "the dissent's interpretation of § 104(a)(2) is reasonable" (Pet. App. at 8a n.4), and that even the IRS had "twice reversed its opinion as to whether § 104(a)(2) excludes punitive damages awarded in a personal injury suit" (Pet. App. at 5a n.2), and urged Congress to "clear up the issue." *Id.* at 10a n.7.

The majority accepted the government's argument that Section 104(a)(2) requires a taxpayer to prove both that (1) the damages were recovered in a tort-like suit, and (2) the damages were received "on account of the personal injury." *Id.* at 8a. While recognizing that the Hawkinses' punitive damages were indisputably recovered in a tort-like suit, the majority concluded that the punitive

damages were not received "on account of personal injuries" because they are not compensatory in nature and bear no relationship to actual injuries. In support of its conclusion, the majority argued that the rationale undergirding Section 104(a)(2) was the principle that damages received through litigation or agreement should not be taxed when they represented a "restoration of capital." *Id.* at 11a-12a (quoting *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962)) (" 'Damages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss to personal rights because, in effect, they restore a loss to capital' "). The majority concluded that as the Hawkinses' punitive damages were not compensatory, they represented a windfall and not a restoration of capital, and should therefore not be excluded from gross income pursuant to Section 104(a)(2). Pet. App. at 12a-13a.

In dissent, Judge Trott observed that the exclusion from gross income in Section 104(a)(2) of *"any* damages" (emphasis added) received on account of personal injury "suggests 'all damages' " and "simply does not permit a distinction between compensatory and punitive damages": "If Congress intended to exclude only compensatory damages from gross income, it certainly could have made that distinction explicit." *Id.* at 14a.

Instead of the two-part test followed by the majority, the dissent adopted the approach of a nearly unanimous Tax Court sitting en banc in *Horton*: "The beginning and end of the inquiry should be whether the damages were paid on account of 'personal injuries.' This inquiry is answered by determining the nature of the underlying claim." *Id.* at 16a (quoting *Horton v. Commissioner*, 100 T.C. at 96). Because the Hawkinses' underlying claim was for "personal injury," the dissent concluded that punitive damages received on account of that claim were excludable.

The dissent found support for its interpretation of Section 104(a)(2) in this Court's decision in *Burke*,

which focused on the nature of the underlying claim as the sole determinant of exclusion under Section 104(a)(2). Citing the statement in *Burke* that "the concept of a 'tort' is inextricably bound up with remedies," the dissent reasoned that because punitive damages are one of the primary indicia of a personal injury claim, it follows that punitive damages are received "on account of personal injury." Pet. App. at 17a. The dissent rejected the "illogical" conclusion that, while the availability of punitive damages made the claim tort-like and rendered compensatory damages excludable from gross income under Section 104(a)(2), the punitive damages themselves are unrelated to the personal injury and should be taxable.

The dissent further noted that Section 104(a)(2) was amended, effective July 10, 1989, to provide that the section's exclusion from gross income "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379.[1] The dissent cited *Burke*, 112 S. Ct. at 1877 n.6, for the proposition that "Congress amended § 104(a) to allow the exclusion of punitive damages only in cases involving 'physical injury or physical sickness.'" Pet. App. at 18a-19a. The dissent pointed out that, while "[c]ommentators overwhelmingly agree with this interpretation of the 1989 amendment" (*id.* at 19a n.3), the majority's apparent position that all punitive damages are taxable, both before and after 1989, meant that the 1989 amendment "had no effect." *Id.*

Finally, the dissent criticized the majority's embrace of the rationale of the restoration of capital as the basis for Section 104(a)(2), a rationale which the dissent pointed out "has been widely criticized as a means of explaining the § 104(a)(2) exclusion." *Id.* at 20a. This theory

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[1] The amendment does not apply to punitive damages received under agreements made, or pursuant to suits filed, before July 10, 1989. *Id.*

could not explain why compensatory damages (e.g., lost wages) were *not* taxable while the items for which they compensated would have been had they been received in the ordinary course. Moreover, the theory would require an absurd effort to find the tax basis for the human body, since any damages in excess of that basis would be a windfall rather than a restoration of capital. *Id.*

## REASONS FOR GRANTING THE WRIT

The Ninth Circuit's ruling—that Section 104(a)(2) does not exclude from gross income punitive damage awards received in personal injury suits because such damages are not compensatory in nature—warrants review by this Court for three reasons. First, there is not only a conflict between the circuits, but a conflict within the Ninth Circuit as well as a conflict with the Tax Court, a national court given the primary responsibility for interpreting the nation's tax laws. The Ninth Circuit's decision in *Hawkins*, as well as the Fourth Circuit's decision in *Miller v. Commissioner* and the Federal Circuit's decision in *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994), squarely conflict with the Sixth Circuit's decision in *Horton v. Commissioner*, 33 F.3d 625 (6th Cir. 1994). The decision in *Hawkins* also conflicts with the Ninth Circuit's decision in *Schmitz v. Commissioner*, 34 F.3d 790 (9th Cir. 1994),[2] and its decision eleven years earlier in *Roemer*.[3] Finally, *Hawkins* is in conflict with

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[2] The government has acknowledged this intra-circuit split in its Petition for Writ of Certiorari in *Commissioner v. Schleier*, No. 94-500 (cert. granted November 14, 1994). Pet. App. at 40a-41a ("as Judge Trott noted concurring in the result in *Schmitz* . . ., the Ninth Circuit's decision . . . conflicts with the Ninth Circuit's own prior decision in *Hawkins v. United States*").

[3] The majority in *Hawkins* departed from *Roemer* on the ground that *Roemer* relied solely "on a 1975 Revenue Ruling which has since been overruled." Pet. App. at 8a. *See* n.13, *infra*. *Roemer* was cited with approval by the Supreme Court just two years earlier. *Burke*, 112 S. Ct. 1871 n.6.

the nearly unanimous holdings of the Tax Court in *Miller* and *Horton*. While *Miller* has been reversed by the Fourth Circuit, the Sixth Circuit affirmed the Tax Court in *Horton*, thus making it unlikely that the Tax Court will alter its position. This lack of uniformity throughout the judicial system, with respect to an important provision of the Internal Revenue Code, ought not to be allowed. Resolution of these conflicts are necessary to prevent taxpayers from being subject to federal taxation, or not, depending upon the happenstance of their residence.

Second, the Ninth Circuit's approach in this case was fundamentally wrong. The court had no justification for departing from the language of the statute in favor of a dubious policy rationale—especially when such an approach is at odds with the implications of this Court's decision in *Burke* and Congress' 1989 amendment. The statute plainly provides that "any damages" received "on account" of personal injury are excluded from gross income. The most straightforward way to understand this language, especially in light of the 1989 amendment, is that "any" (that is, "all") damages received "on account of" (that is, "through a claim for") personal injury are not taxable.[4]

Finally, the meaning of Section 104(a)(2) is of continuing importance and is before the Court this term in *Commissioner v. Schleier*, No. 94-500 (cert. granted November 14, 1994). In that case, the government has argued that liquidated damages received under the Age Discrimination and Employment Act ("ADEA"), 26 U.S.C.

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[4] Notwithstanding the *Hawkins* majority's view that Section 104(a)(2) is "ambiguous," the government now contends in its Petition for Certiorari in *Schleier* that the plain meaning of the statute would exclude punitive damages. Pet. App. at 39a ("Punitive damages . . . do not come within the literal terms of the exclusion from income provided by Section 104(a)(2). That conclusion . . . appears plain enough on the face of the statute.") (footnote omitted).

§§ 621 et seq., should not be excluded from gross income under Section 104(a)(2). In its Petition for Certiorari in *Schleier*, the government argues that Section 104(a)(2) should be interpreted according to precisely the same two-part test adopted by the Ninth Circuit majority here and that liquidated damages received under ADEA should accordingly not be excluded from income because, like punitive damages, they are not "on account of" personal injuries. In support of this argument, the government cites the appellate decision in this case, as well as those in *Miller* and *Reese*. Pet. App. at 38a-39a. Fairness, completeness, and judicial economy counsel resolution of the overlapping circuit conflicts presented in *Schleier* and here.

## I. THE DECISION BELOW SQUARELY CONFLICTS WITH A RULING FROM THE SIXTH CIRCUIT; MOREOVER, THE FEDERAL JUDICIARY IS IN DISARRAY WITH RESPECT TO THE ISSUE RAISED HEREIN.

The Ninth Circuit's decision, as well as the decisions of the Fourth Circuit in *Miller* and the Federal Circuit in *Reese*, squarely conflict with the Sixth Circuit's decision in *Horton* and two nearly unanimous opinions of the United States Tax Court sitting en banc. *See Miller v. Commissioner*, 93 T.C. 330, 338 (1989), *rev'd* 914 F.2d 586 (4th Cir. 1990) (15 to 2 decision); *Horton v. Commissioner*, 100 T.C. 93, 95 (1993), *aff'd* 33 F.2d 625 (6th Cir. 1994) (16 to 3 decision expressly rejecting the reasoning and holding of the Fourth Circuit in *Miller*). It also conflicts with the Ninth Circuit's previous ruling in *Roemer*.[5]

The Sixth Circuit's opinion in *Horton* was rendered two months after the Ninth Circuit's divided decision here. In

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[5] Although the conflict with *Roemer* was argued by the Hawkinses as a principal reason for their suggestion for rehearing en banc, no active Ninth Circuit judge requested a vote on the Hawkinses' suggestion. Pet. App. at 25a.

*Horton*, the panel, also divided, discussed and explicitly rejected the Ninth Circuit's holding and rationale. *Horton* also considered and rejected the arguments advanced in *Miller* and *Reese*.[6]

The Sixth Circuit in *Horton* addressed each of the arguments advanced by the Ninth Circuit in *Hawkins* and found them wanting.[7] While the Ninth Circuit found the Supreme Court's decision in *Burke* to be "unpersuasive" (Pet. App. at 8a), the Sixth Circuit found it to be "instructive" and its language to be "directive." *Horton*, 33 F.3d at 629, 630.[8] While the Ninth Circuit thought the language of Section 104(a)(2) to be "ambiguous" (Pet. App. at 5a), the Sixth Circuit felt its meaning to be "plain." *Horton*, 33 F.3d at 631. While the Ninth Circuit found the 1989 amendment to Section 104(a)(2) to be only a "clarif[ication of] existing law," and "doubt[ed] that Congress intended [by it] to exclude *any* noncompensatory punitive damages" (Pet. App. at 10a and 10a n.7, emphasis added), the Sixth Circuit concluded that "the clear implication of [the amendment] is that punitive damages in a case involving physical injury or physical

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[6] The majority in *Horton* noted that it "disagree[d] with the Ninth Circuit's opinion in *Hawkins*, the Federal Circuit's opinion in *Reese*, and the Fourth Circuit's opinion in *Miller*. We agree with the cogent reasoning of Judge Trott's dissenting opinion in *Hawkins*." *Horton*, 33 F.3d at 630 n.9.

[7] The arguments adopted by the Ninth Circuit in *Hawkins* are substantially the same as the arguments advanced by the Fourth Circuit in *Miller* and the Federal Circuit in *Reese*.

[8] In *Burke*, the Supreme Court "focused, for purposes of § 104(a)(2), on the nature of the claim underlying respondents' damages award. . . . In order to come within the § 104(a)(2) income exclusion, respondents . . . must show that Title VII . . . redresses a tort-like personal injury." *Burke*, 112 S. Ct. at 1872. *Horton* cited *Burke* as approving the Sixth Circuit's view, as articulated in *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988), that "the narrow scope of our gaze is properly limited to the 'origin and character of the claim.'" *Horton*, 33 F.3d at 630.

sickness are excludable, and were excludable even before the amendment." *Horton*, 33 F.3d at 631 n.12. While the Ninth Circuit believed that the purpose of Section 104(a)(2) was to exclude from gross income damages that "make the taxpayer whole . . . [by] restor[ing] a loss to capital" (Pet. App. at 11a), the Sixth Circuit found the distinction between damages which make a taxpayer "whole" and those which are "mere accessions to wealth" to be a "false dichotomy." *Horton*, 33 F.3d at 632. What both circuits might have agreed on was that "[w]e proceed knowing that '[a] consensus on this issue within the federal judiciary is nonexistent.'" *Id.* at 627 (citation omitted).[9]

The practical import of this lack of consensus is evident. In the Ninth and Fourth Circuits, the Tax Court will be compelled to follow the rule that punitive damages in connection with personal injury claims are not excluded from gross income. In all other circuits, including the Sixth, the Tax Court will apply the contrary rule.[10]

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[9] As but one of its numerous grounds for holding that punitive damages were excluded from gross income under Section 104(a)(2), the majority in *Horton* noted that the Kentucky Supreme Court had indicated that punitive damages had a compensatory component in that "'the *injury* has been *increased* by the *manner* [in which] it was inflicted,'" *Horton*, 33 F.3d at 631 (citation omitted) (emphasis in original), and suggested that this might be a factor distinguishing *Horton* from *Hawkins*. The dissent properly noted, however, that the Kentucky Supreme Court's "explanation of why the concept of punitive damages should not be discarded [does not] make[] punitive damages in Kentucky somehow different from other states." *Id.* at 632. Other courts have attempted to explain punitive damages in a fashion similar to that of Kentucky. *See* W. Page Keeton *et al.*, *Prosser* and *Keeton on the Law of Torts* § 2, at 9 (5th ed. 1984) ("Occasional decisions have mentioned the additional purpose of [punitive damages of] reimbursing the plaintiff for elements of damages which are not legally compensable, such as wounded feelings or the expenses of suit") (footnote omitted).

[10] The Tax Court considered the Fourth Circuit's reversal in *Miller* yet hewed to its reasoning when revisiting the issue in

Immediate resolution of this conflict between the circuits, and between several of the circuits and the Tax Court, is necessary to prevent taxpayers in different circuits from being subject to disparate federal tax treatment.[11]

There is no possibility that this conflict will ameliorate of its own accord. Its existence was brought to the attention of the Ninth Circuit in the Hawkinses' petition for rehearing while the Hawkinses' petition for rehearing and suggestion for rehearing en banc was pending, yet rehearing was denied. The Sixth Circuit in *Horton* was similarly cognizant of the split, yet specifically refused to follow the Ninth Circuit, the Fourth Circuit, and the Federal Circuit. The time for seeking rehearing in *Horton* has expired, and the mandate has issued. The Fourth Circuit decision in *Miller* and the Federal Circuit's decision in *Reese* are also final.

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*Horton*. Now that the Tax Court's approach has been vindicated by the Sixth Circuit, there can be little doubt that the Tax Court will continue to recognize the excludability of punitive damages received in personal injury suits in all circuits in which it has the authority to do so, i.e., everywhere outside of the Fourth and Ninth Circuits.

[11] The Tenth Circuit is likely to be the next to take sides in this circuit split. In *O'Gilvie v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,567 (D. Kan. 1992), the district court initially held, relying on the Fourth Circuit's decision in *Miller*, that punitive damages in a wrongful death suit were not excludable from gross income. However, following this Court's decision in *Burke*, the district court reconsidered its determination and, in an unpublished decision, reversed itself. *See id.* at ¶ 85,974-75 ("The Supreme Court's opinion [in *Burke*] makes clear that the proper inquiry for purposes of § 104(a)(2) is on the nature of the claim underlying the taxpayers' damages award"). The district court's decision is presently on appeal to the Tenth Circuit.

## II. THE NINTH CIRCUIT'S APPROACH FLOUTS THE PLAIN LANGUAGE OF THE STATUTE, IS INCONSISTENT WITH THE GOVERNING TREASURY REGULATION, RESTS ON A DISCREDITED POLICY RATIONALE, AND IS AT ODDS WITH THE 1989 AMENDMENT AS WELL AS THE SUPREME COURT DECISION IN *BURKE*.

On the merits, it is difficult to defend the Ninth Circuit's decision in this case to abandon the language of the statute in favor of a policy rationale that has been thoroughly discredited.[12]

A. Section 104(a)(2) provides that gross income does not include "*any* damages received . . . on account of personal injuries or sickness" (emphasis added). The plain meaning of Section 104(a)(2) is that *"any"* damages, that is *all* damages, received on account of personal injury are excluded from gross income. That should be the end of the analysis. *See Crane v. Commissioner*, 331 U.S. 1, 6, 67 S. Ct. 1047, 1051 (1947) ("the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses").

The majority suggests that Section 104(a)(2) is ambiguous in two ways. First, it states that " '[d]amages received on account of personal injury [sic]' could mean all damages received in a personal injury lawsuit, or, it could mean only those damages which purport to compensate the taxpayer for her personal injuries." Pet. App. at 5a.

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[12] In dissent, Judge Trott posited that the majority's approach was borne of good intentions:

> The majority tries to impose some logic and commonsense [sic] on § 104(a)(2). Despite their efforts, I fear they might sow more confusion than clarification. Congress should straighten out this mess, but until they do, we must do our best to apply the statute as it is written and as we believe Congress intended. We cannot contradict the statute's plain language in an effort to impose order in the sometimes-chaotic world of the tax code.

Pet. App. at 21a.

But the majority's choice of the latter construction of Section 104(a)(2), by which the exclusion applies to "compensatory" damages only, runs afoul of the text, which explicitly provides that the exclusion applies to "any damages" received on account of personal injury. As the dissent observes, "any damages" surely suggests "all damages." Pet. App. at 14a; *see also Horton v. Commissioner*, 100 T.C. at 95.[13]

Cognizant of this problem, the majority attempts to disarm the nettlesome word "any" by suggesting that it "could indicate an intent to make all of the[] various kinds of compensatory damages excludable." Pet. App. at 6a n.3. This interpretation begs the question, however, because it requires that "any damages" be read as "any compensatory damages."

Alternatively, the majority argues that the phrase "on account of" personal injury "could mean . . . all damages to which a litigant is entitled because of her injuries, but not those which serve solely to punish the wrongdoer." *Id.* This strained reading of "on account of" again departs from the text. It requires effective emendation of the statute so that Section 104(a)(2) states, "any damages . . . on account of personal injury[, unless they serve solely to punish the wrongdoer]." This is not what Congress wrote.

Moreover, this interpretation of the phrase "on account of" is contrary to Treasury Regulation Section 1.104-1(c),

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[13] At one time, the Commissioner acknowledged this point. *See* Revenue Ruling 75-45, 1975-1 C.B. 47 ("Section 104(a)(2) . . . excludes from gross income 'the amount of *any* damages received . . . *on account of* personal injuries or sickness' . . . Therefore, under section 104(a)(2) any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable from gross income") (emphasis in original). The Commissioner later reversed his position in Revenue Ruling 84-108, 1984-2 C.B. 32, 34, based primarily on a mistaken understanding of an inapposite Supreme Court case. *See Miller*, 93 T.C. at 339.

promulgated under Section 104(a)(2). Treasury regulations, which set forth the Treasury's official interpretation of the revenue statutes, are entitled to considerable deference. *See Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 501, 68 S. Ct. 695, 698 (1948) (Treasury regulations must be upheld "unless unreasonable and plainly inconsistent with the revenue statutes").[14]

In the apposite regulation, the Treasury interprets "damages received" to mean "an amount received (other than workmen's compensation) *through* prosecution of a legal suit or action based upon tort or tort type rights, or *through* a settlement agreement entered into in lieu of such prosecution." 26 C.F.R. § 1.104-1(c) (1991) (emphasis added).[15] Although the regulation ostensibly defines only the meaning of "damages received," it gives sense to the entire phrase "damages received . . . on account of personal injuries." In doing so, the Treasury regulation looks only to the causal source of the damage—tort or tort type rights—to determine excludability, not the type of damage received. Indeed, in *Burke*, a majority of this Court accepted the soundness of this Treasury regulation and deferred to it. *See Burke*, 112 S. Ct. at 1875 (Scalia, J., concurring in the judgment) ("The court accepts at the outset of its analysis the Internal Revenue Service regulation"); *see also id.* at 1878 (O'Connor, J., dissenting) ("The Court properly defers to an Internal Revenue Service . . . regulation").

The majority's suggestion that Congress intended a distinction that is not articulated in the statute is thus inconsistent with normal canons of interpretation, *see Crane*, 331 U.S. at 6. 67 S. Ct. at 1051, as well as the Treasury's

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[14] The same deference is not due to Revenue Rulings. *Dixon v. United States*, 381 U.S. 68, 73, 85 S. Ct. 1301, 1304 (1965); *Propstra v. United States*, 680 F.2d 1248, 1256 (9th Cir. 1982) (Revenue Rulings are only "occasionally entitled to weight in the interpretive process").

[15] The Ninth Circuit majority did not consider, much less explain, its departure from the governing Treasury regulation.

view of the meaning of the statute. It is also contrary to common sense. As the Tax Court observed, "Congress, aware of [the availability of punitive damages], could have excluded only 'compensatory damages' or provided that only damages received 'as compensation for' personal injuries be excluded. . . . It did neither." *Horton*, 100 T.C. 93, 95 (1993) (quoting *Miller v. Commissioner*, 93 T.C. at 338).

B. The crux of the majority's analysis is that Section 104(a)(2) is ambiguous. The majority then posits its policy rationale—"restoration of capital"—and attempts to interpret the statute in its light.

Even were the majority correct that the language of Section 104(a)(2) did not compel the exclusion from gross income of punitive damages obtained in tort type cases, its reliance on a restoration of capital rationale to interpret the statute is misplaced. In *Burke*, 112 S. Ct. at 1871 n.6 (1992), this Court described Section 104(a)(2), amended in 1989, as "allow[ing] the exclusion of *punitive* damages . . . in cases involving 'physical injury or physical sickness' " (emphasis in original). In other words, this Court recognized that at least one class of punitive damages—those in cases involving physical injury—is excluded from income. Were restoration of capital the rationale for Section 104(a)(2), no punitive damages should be excludable.

The majority in *Hawkins* was aware of this inconsistency, albeit unable to overcome it. Instead, the majority conceded the issue, forthrightly noting that "[g]iven our belief that excluding punitive damages is inconsistent with § 104(a)(2)'s title and purpose, we doubt that Congress intended to exclude any noncompensatory punitive damages." Pet. App. at 10a n.7. The majority's conclusion, which is driven by the restoration of capital rationale, is flatly inconsistent with *Burke*.[16]

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[16] The same problem faces the government in *Schleier*, where it also urges a construction of Section 104(a)(2) that would result

Even were the restoration of capital theory not at loggerheads with this Court's precedent, the Tax Court and numerous commentators have observed that the restoration of capital theory cannot explain Section 104(a)(2) because the provision excludes damages that are a substitute for "items that otherwise would be taxable or would potentially produce taxable benefit, such as income lost as a result of a personal injury or amounts reflecting injury to a person's business or professional reputation," i.e., items that are conceptually income rather than returned capital. *Downey v. Commissioner*, 97 T.C. 150, 163 (1991), supp. op., 100 T.C. 634 (1933), *rev'd on other grounds*, 33 F.3d 836 (7th Cir. 1994); *see also Horton*, 100 T.C. at 96 n.4 (citing commentators). Moreover, the core concept of the restoration of capital rationale—the existence of "human capital" that can be restored—finds no recognition in the Tax Code. In the words of one commentator:

> If a personal injury involves a loss of human capital, then it follows that there should be a deduction for uncompensated personal injury losses [, but] no such deduction exists. . . . [I]f one has basis in human capital, there should be depreciation deductions to offset wages, but again none exist.

Joseph M. Dodge, *Taxes and Torts*, 77 Cornell L. Rev. 143, 153 (1992) (footnotes omitted).

In sum, whatever the policy appeal of the restoration of capital rationale, it cannot explain Section 104(a)(2). It thus cannot be used as the touchstone for correct interpretation of the statute.[17]

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in all punitive damages being included in gross income. There, the government has attempted to overcome this Court's statement in *Burke* by characterizing it as mere "dicta." Pet. App. at 39a n.10.

[17] Commentators have concluded that no single policy can adequately account for items excluded under Section 104(a). *See, e.g.*, Margaret Henning, *Recent Developments in the Tax Treatment*

C. In 1989, Congress amended Section 104(a)(2) to provide that the provision's exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (1989). This amendment does not apply to any recovery of punitive damages under an agreement made, or pursuant to a suit filed, on or before July 10, 1989. *Id.* at § 7641(b)(2). The reasonable implication from the 1989 amendment is that, as to recoveries on suits filed or agreements made prior to July 10, 1989, all punitive damages on account of personal injury were not taxable; as to recoveries on suits filed or agreements made after July 10, 1989, only punitive damages received in personal injury cases involving physical injury or sickness are excludable. *See Burke*, 112 S. Ct. at 1871 n.6 ("Congress amended § 104(a) to allow the exclusion of *punitive* damages only in cases involving 'physical injury or physical sickness' ") (emphasis in original).

The 1989 amendment makes no sense—and has no effect—if viewed with the majority's assumption that before that year Section 104(a)(2) did not apply to any type of punitive damages—those arising in physical injury as well as nonphysical injury cases. The majority in *Hawkins* also recognized this difficulty, but rationalized that Congress may have engaged in an effectively pointless amendment to "clarify existing law." Pet. App. at 9a. This conjecture offends common sense, however, for "if Congress wanted to clarify that all punitive damages were taxable, why did the amendment create a distinction between physical and nonphysical injury?" Pet. App. at 19a (Trott, J., dissenting). In short, the 1989 amendment is further evidence that punitive damages obtained in all personal injury suits were excludable from gross income prior to 1989.

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*of Personal Injury and Punitive Damage Recoveries*, 45 Tax Law. 783, 795-97 (1992).

## III. THE ISSUE PRESENTED IS ONE OF CONTINUING IMPORTANCE.

The interpretation of pre-amendment Section 104(a)(2) "remains one of substantial importance in the administration of the income tax laws for earlier taxable years." *Colony Inc. v. Commissioner,* 357 U.S. 28, 32, 78 S. Ct. 1033, 1035 (1958); *see also Watson v. Commissioner,* 345 U.S. 544, 547, 73 S. Ct. 848 (1953) (certiorari granted to resolve conflicting constructions of amended provisions of Internal Revenue Code because of significance for earlier taxable years). The 1989 amendment does not apply to recoveries of punitive damages in connection with suits filed before July 10, 1989. Many such suits may still be pending, or recoveries thereon subject to audit for years to come. Given the frequency of punitive damages awards, the resolution of the circuit split at bar has potential ramifications for untold numbers of taxpayers. *Cf. Pacific Mut. Life Ins. Co. v. Haslip,* 499 U.S. 1, 61, 111 S. Ct. 1032, 1066 (1991) (O'Connor, J., dissenting) (citations omitted) ("Recent years . . . have witnessed an explosion in the frequency and size of punitive damages awards. . . . A recent study by the RAND Corporation found that punitive damages were assessed against one of every ten defendants who were found liable for compensatory damages in California").

Moreover, on November 14, 1994, this Court granted review in *Commissioner v. Schleier,* No. 94-500, which raises a similar issue as to the meaning of the same pre-amendment language of Section 104(a)(2) as is at issue here. ADEA provides a remedy for wrongful discharge damages equal to back pay, plus an award of "liquidated damages" in an amount equal to the back pay award "in cases of willful violations." 29 U.S.C. § 626(b). It is well established that "ADEA liquidated damages do not duplicate state damage awards for lost interest, emotional distress, and pain and suffering." *Schmitz,* 34 F.3d at 796 n.8.

Schleier obtained a settlement for back pay and liquidated damages in 1986, and thereafter asserted that both were excluded from gross income under the pre-1989 amendment language of Section 104(a)(2). The Tax Court followed its earlier decisions in *Downey v. Commissioner*, 97 T.C. 150 (1991), supp. op., 100 T.C. 634 (1993), *rev'd*, 33 F.3d 836 (7th Cir. 1994), which held that liquidated damages, notwithstanding their partially punitive purpose, were "on account of personal injuries" since ADEA "evidences a tort-like conception of injury and remedy." *Downey*, 100 T.C. at 637. The Fifth Circuit affirmed in an unpublished opinion, *Schleier v. Internal Revenue Service*, No. 93-5555 (filed June 21, 1994), thus aligning itself with the Ninth Circuit decision in *Schmitz* and placing it in opposition to the Seventh Circuit's decision in *Downey*.

Like *Schleier*, the issue raised in the present Petition is whether, under the pre-1989 amendment language of Section 104(a)(2), the test for exclusion from gross income is the nature of the action (is it a tort-like suit?) or the nature of the remedy (does it serve a compensatory or punitive purpose?). Thus, in its Petition for Certiorari in *Schleier*, the government argues:

> Even if the ADEA were thought to represent a tort-type remedy for a personal injury, any liquidated damages awarded under that Act would not be excludable from gross income under Section 104 (a)(2). When applicable, Section 104(a)(2) permits exclusion only of damages received "on account of" personal injuries . . . . As the Fourth Circuit concluded in *Commissioner v. Miller*, damages awarded as punishment of a wrongdoer, rather than as compensation for an injury, are awarded "on account of" malice or willfulness, not "on account of" personal injury. 914 F.2d at 589-592. Accord, *Hawkins v. United States* . . .; *Reese v. United States* . . . . Punitive damages and statutory penalties for "willful violations" of the law thus do not come within

> the literal terms of the exclusion from income provided by Section 104(a)(2) . . . .
>
> . . . . .
>
> In our view, the conclusion expressly reached . . . by the Ninth Circuit in *Schmitz* . . . conflicts with the conclusion of the Fourth and Federal Circuits in *Commissioner v. Miller, supra,* and *Reese v. United States, supra,* that damages awarded to penalize a wrongdoer are not awarded "on account of personal injuries" within the meaning of Section 104(a)(2). Moreover, as Judge Trott noted concurring in the result in *Schmitz* . . . the Ninth Circuit's decision on this issue conflicts with the Ninth Circuit's own prior decision in *Hawkins v. United States* . . . .

Pet. App. at 38a-41a (citations and footnotes omitted). Thus, in *Schleier,* the government has squarely put the interpretation of Section 104(a)(2) followed by the *Hawkins* majority before this Court for decision. This Court's determination of whether liquidated damages, imposed for "willful violations" of ADEA, are "on account" of personal injury ought, and is likely, to include an analysis of the similarities between liquidated and punitive damages. As Judge Trott wrote in his concurring opinion in *Schmitz*:

> The majority . . . has to square this result with the test they created in *Hawkins.* . . . I don't see how the majority can distinguish ADEA liquidated damages from punitive damages. I think this inconsistency merits attention because it demonstrates problems with the majority's approach in both this case and *Hawkins.*

34 F.3d at 797 (Trott, J., concurring).

The circuit split on punitive damages thus mirrors and overlaps the circuit split on ADEA liquidated damages. For reasons of completeness, fairness, and judicial economy these related issues should be resolved. Although deferring action on this Petition until *Schleier* is decided might assure no blatant inconsistency between the result

applicable to the Schleiers and that applicable to Petitioners here, it would not assure the full resolution of this recurring issue. Whether liquidated damages imposed for willful violations of ADEA, and punitive damages awarded for egregious conduct, should be excluded from income ought to be decided through consistent reasoning.

Finally, the meaning of the phrase "damages received . . . on account of personal injuries," as used in Section 104(a)(2), has important, continuing ramifications as to the proper tax treatment of punitive damages received in connection with agreements made or suits filed after July 10, 1989, in cases involving physical injury. Even as to such post-July 10, 1989 agreements or suits, if the interpretation urged by the *Hawkins* majority, and the government in *Schleier*, of the phrase "on account of" is correct, no punitive damages, including punitive damages received in cases involving physical injury or sickness, are excludable from gross income. Rejection of the *Hawkins* majority's interpretation of "on account of" would, conversely, allow for the exclusion of punitive damages received in connection with an agreement made or suit filed after July 10, 1989, in a case involving physical injury or sickness.

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

GREGORY R. SMITH
(Counsel of Record)
LAWRENCE M. STONE
ELLIOT BROWN
IRELL & MANELLA
1800 Avenue of the Stars
Suite 900
Los Angeles, CA 90067
(310) 277-1010

**APPENDIX A**

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

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No. 93-15828

JACK R. HAWKINS, CYNTHIA J. HAWKINS, husband & wife,
*Plaintiffs-Appellees,*

v.

UNITED STATES OF AMERICA,
*Defendant-Appellant.*

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**Appeal from the United States District Court for the District of Arizona**

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Argued and Submitted April 11, 1994

Decided July 19, 1994

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Before GOODWIN, FERGUSON and TROTT, Circuit Judges.

Opinion by Judge GOODWIN; Dissent by Judge TROTT.

GOODWIN, Circuit Judge:

The government appeals a summary judgment granted in favor of Jack and Cynthia Hawkins ("the taxpayers"). The district court concluded that the taxpayers' punitive damage award was excludable from gross income as "damages received . . . on account of personal injury." 26 U.S.C. § 104(a)(2). We reverse.

I.

The facts are undisputed. In 1979, Cynthia Hawkins crashed the taxpayers' $8,000 car, totaling it. Ms. Hawkins and her husband ("the Hawkinses") filed a claim with their insurer, Allstate Insurance Company ("Allstate"), requesting a replacement car. Allstate agents allegedly pressured the couple into buying an inferior, less expensive replacement car for $6,741, and then failed to equip the new car with certain options. The Hawkinses sued Allstate for breach of good faith and fair dealing (insurance bad faith), ultimately recovering $15,000 in compensatory damages and $3.5 million in punitive damages. *Hawkins v. Allstate Insurance Co.*, 152 Ariz. 490, 733 P.2d 1078, *cert. denied*, 484 U.S. 874, 108 S.Ct. 212, 98 L.Ed.2d 177 (1987).

On their 1988 federal income tax return, the Hawkinses initially reported $2,937,406 of the lawsuit proceeds as gross income, contending that the punitive damages (less attorneys' fees and costs) were taxable, but that the $15,000 compensatory damages were excludable "damages received on account of personal injury or sickness." 26 U.S.C. § 104(a)(2). They then filed an amended return, claiming that the punitive damages were also excludable under § 104(a)(2) and requesting a refund of $793,277. The IRS disallowed the refund, and the Hawkinses filed this refund action in the district court. On cross-motions for summary judgment, the district court found for the Hawkinses, ruling that the punitive damages were excludable. The government timely appealed.

II.

Viewing the evidence in the light most favorable to the non-moving party, we review de novo to determine whether there are any genuine issues of material fact and whether the district court correctly applied the relevant substantive law. *Stevens v. Moore Business Forms, Inc.*, 18 F.3d 1443, 1446 (9th Cir.1994). The case presents no gen-

uine issues of material fact and summary judgment was appropriate. However, we disagree with the district court's interpretation of the relevant law, and hold that the taxpayers' punitive damages were not excludable under § 104(a)(2) (1988).

III.

For taxation purposes, gross income includes "all income from whatever source derived." 26 U.S.C. § 61(a). An accession to wealth, such as the Hawkinses' punitive damage award, is presumed to be taxable income, unless the taxpayer can demonstrate that it fits into one of the Tax Code's specific exemptions. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430, 75 S.Ct. 473, 476, 99 L.Ed. 483 (1985). The Hawkinses contend that their punitive damage award fits into § 104(a)(2), which provides:

> § 104. Compensation for injuries or sickness
>
> . . . [G]ross income does not include— . . . (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) *on account of personal injuries* or sickness;

26 U.S.C. § 104(a)(2) (1988) (emphasis added).[1] IRS implementing regulations define "damages" as amounts received "through prosecution of a legal suit or action based upon tort or *tort-type rights.*" 26 C.F.R. § 1.104-1(c) (1988) (emphasis added).

The parties agree that, under Arizona law, the Hawkinses' bad faith lawsuit was a tort-type action. *Rawlings*

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[1] Congress has since amended § 104(a)(2). *See* Pub.L. No. 101-239, § 7641(a), 103 Stat. 2379 (1989) (providing that punitive damages recovered in non-physical injury cases are not excludable from gross income). This amendment applies to amounts received after July 10, 1989 and therefore does not apply to the Hawkinses' award.

*v. Apodaca,* 151 Ariz. 149, 726 P.2d 565, 567 (1986); *Noble v. National American Life Insurance Co.,* 128 Ariz. 188, 624 P.2d 866, 868 (1981), and that the Hawkinses suffered "personal injuries" as a result of Allstate's conduct. *Bates v. The Superior Court of the State of Arizona, In and For the County of Maricopa,* 156 Ariz. 46, 749 P.2d 1367, 1370 (1988) (mental distress suffered as a result of an insurance company's bad faith refusal to pay a legitimate claim can qualify as a personal injury); *Lange v. Penn Mutual Life Ins. Co.,* 843 F.2d 1175, 1178 (9th Cir.1988). The government therefore concedes that the Hawkinses' *compensatory* damages are excludable "damages received . . . on account of personal injury." § 104(a)(2).

The parties also agree that the Hawkinses' compensatory damages completely covers the Hawkinses' actual injuries, including their two-week loss of the family car, out-of-pocket losses of less than $1,000, and attendant emotional distress. The Hawkinses concede that the punitive damage award bears no relationship to their injuries and represents pure gain.

Thus, the only dispute is whether the punitive damages, despite their tangential relationship to any actual injury, are excludable from gross income under § 104(a). We must decide whether § 104(a) excludes all damages received in a tort-like lawsuit, or only those damages which have some compensatory purpose. The government contends that noncompensatory, punitive damage awards such as the Hawkinses' are not received "on account of personal injuries," but on account of the tortfeasor's egregious conduct. In the government's view, § 104(a)(2) excludes only those damages which purport to compensate the taxpayer for her injuries. The Hawkinses, in contrast, contend that, under the 1988 version of § 104(a)(2), all damages received in a tort-like lawsuit are excludable, regardless of their purpose.

While the Hawkinses' position draws some support from the IRS's vacillation on the issue,[2] we believe the government's current interpretation is more consistent with § 104(a)'s title and purpose, as well as with the rule that exemptions must be narrowly construed in favor of taxation. We therefore join several other courts in concluding that § 104(a)(2) does not exclude noncompensatory punitive damages. *See Reese v. Commissioner,* 24 F.3d 228, (Fed.Cir.1994); *Commissioner v. Miller,* 914 F.2d 586 (4th Cir.1990); *Estate of Wesson v. United States,* 843 F.Supp. 1119 (S.D.Miss.1994); *Kemp v. Commissioner,* 771 F.Supp. 357, 359 (N.D.Ga. 1991).

A.

Unlike the district court, we are not convinced that the "plain meaning" of § 104(a)(2) compels exclusion of punitive damages. Rather, as the Fourth and Federal Circuits have noted, § 104(a)(2) is "ambiguous." *Reese,* 24 F.3d at 230; *Miller,* 914 F.2d at 589-90. "Damages received on account of personal injury" could mean all damages recovered in a personal injury lawsuit, or, it could mean only those damages which purport to compensate the taxpayer for her personal injuries. *Id.* Punitive damages such as the Hawkinses, which do not purport to compensate the taxpayer for personal injuries and which bear no relation to the severity of the taxpayer's injuries,

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[2] In the last 30 years, the IRS has twice reversed its opinion on whether § 104(a)(2) excludes punitive damages awarded in a personal injury suit. *Compare* Rev.Rul. 58-418, 1958-2 C.B. 18 (1958) (punitives awarded in a libel suit not excludable) *with* Rev.Rul. 75-45, 1975-1 C.B. 47 (1975) (any damages, whether compensatory or punitive, received on account of personal injuries or sickness are excludable) and Rev.Rul. 84-108, 1984-2 C.B. 32 (1984) (punitive damages in a wrongful death suit must be included in gross income). The Tax Court has also consistently held that punitives are excludable. *See Horton v. Commissioner,* 100 T.C. 93. 1993 WL 28557 (1993), appeal pending 93-1929 (6th Cir.); *Miller v. Commissioner,* 93 T.C. 330, 1989 WL 104238 (1989), *rev'd,* 914 F.2d 586 (4th Cir. 1990).

are not necessarily awarded "on account of" personal injury; rather, they are awarded "on account of" the tortfeasor's egregious conduct. *Id.*[3]

We also disagree with the Hawkinses' characterization of the case law as "consistently h[olding] that the inquiry under § 104(a)(2) is limited to an examination of the nature of the taxpayer's claim or injury." Appellees Br. at 15 (citing *United States v. Burke*, —— U.S. ——, ——, 112 S.Ct. 1867, 1870, 119 L.Ed.2d 34 (1992); *Redfield v. Insurance Co. of North America*, 940 F.2d 542 (9th Cir.1991); *Threlkeld v. Commissioner*, 848 F.2d 81 (6th Cir.1988)). While these cases did examine the nature of the taxpayers' claim or injury to determine whether or not the damages at issue were recovered for

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[3] The dissent argues that § 104(a)(2) is not ambiguous because (1) a litigant cannot receive punitive damages unless she has suffered personal injury; and (2) because the statute refers to "any damages." While the dissent's attempt to make sense of the statute is commendable, we respectfully disagree.

First, even if punitive damage awards cannot be awarded "but for" personal injury, the phrase "on account of" does not necessarily mean "but for causation." *Id.* Rather, "on account of" could mean what the *Miller* court called "sufficient causation"—i.e. all damages to which a litigant is entitled because of her injuries, but not those which serve solely to punish the wrongdoer.

The section's reference to "any damages" is no more illuminating. Given the variety of compensatory damages available in tort actions—including specific or actual damages, general damages, loss of consortium damages, emotional distress damages, etc.—"any damages" could indicate an intent to make all of these various kinds of compensatory damages excludable. The word "any" does not, as the dissent suggests, necessarily indicate an intent to make punitive damages excludable.

Finally, the dissent's claim that "[t]he language of § 104(a)(2) simply does not permit a distinction between compensatory and punitive damages" ignores both § 104(a)'s title, "Compensation for Injury and Sickness," and the longstanding rule that exclusions to income are to be construed narrowly in favor of taxation. *See United States v. Centennial Savs. Bank*, 499 U.S. 573, 583-84, 111 S.Ct. 1512, 1518-19, 113 L.Ed.2d 608 (1991); *Commissioner v. Jacobson*, 336 U.S. 28, 69 S.Ct. 358, 93 L.Ed. 477 (1949).

personal injury, they did not hold that whenever the underlying claim is tort-like all damages are excludable.

In fact, the Federal Circuit recently rejected the Hawkinses' exact argument and distinguished precisely these cases. *Reese*, 24 F.3d at 234. As the *Reese* court noted, *Burke* held only that damages awarded under the 1991 version of Title VII were not excludable from gross income because the statute did not "evidence[] a tort-like conception of injury and remedy." —— U.S. at ——, 112 S.Ct. at 1873. The *Burke* taxpayers had not received punitive damages, and the Court did not address the excludability of punitive damages. Rather, the Court mentioned punitive damages only because the Court felt that the availability of punitive damages indicates the nature of the underlying cause of action: Since punitive damages are traditionally available only in personal injury-type actions, the availability of punitives suggests that the underlying cause of action is "tort-like" within the meaning of § 104(a). Contrary to the dissent's arguments, however, nothing about this comment implies that punitive damages *themselves* are excludable from gross income. Punitive damages may be an indicia of a tort-like cause of action without themselves being damages received on account of personal injury.

Nor did the Court indicate that, if the underlying cause of action is tort-like, all damages, regardless of their purpose, are excludable. While the Court "agree[d] with the Court of Appeals' analysis insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying . . . [the taxpayers'] damages award," *Burke*, —— U.S. at ——, 112 S.Ct. at 1872, the Court did not state that courts should look exclusively at the nature of the claim underlying the damage award. The Court's alleged failure to "mention any additional requirements for exclusion under § 104(a)(2)" means little, given that the Court concluded that the taxpayers' underlying cause of action was not "tort-like." The Court had no occasion to discuss any such additional requirements.

The Hawkinses' other cases are similarly unpersuasive. *Redfield*, 940 F.2d 542, addressed ADEA liquidated damages, which serve both to compensate and to punish; *Threlkeld*, 848 F.2d 81, addressed damages for loss of reputation, which similarly have a compensatory purpose. Finally, *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir.1983) relied on a 1975 Revenue Ruling which has since been overruled. *See Miller*, 914 F.2d at 591 (distinguishing *Roemer* on this basis).[4] Thus, contrary to the Hawkinses' arguments, no controlling authority[5] contradicts the government's assertion that, in order to prove excludability under § 104(a)(2), the taxpayer must show both (1) that the damages were recovered in a tort-like suit and (2) that the damages were received on account of the personal injury.

The Hawkinses' reliance on the 1989 amendments to § 104(a)(2) is similarly unconvincing. As the Hawkinses emphasize, Congress has since amended § 104(a)(2) to provide that the exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub.L. No. 101-239, § 7641, 103 Stat. 2106, 2379 (1989). While this amendment applies only to damages received after July 10, 1989, and there-

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[4] In contrast to the dissent, we see no evidence in *Roemer* that the court "independently reviewed the text of the statute." Nor are we accusing the *Roemer* court of "blindly following the Internal Revenue Service's pronouncements on the subject." Rather, we think the court reasonably and appropriately deferred to the IRS's interpretation of § 104(a)(2), under the well-settled rule that an agency's interpretation of a statute is entitled to deference unless it contradicts the statute's plain meaning. *Sullivan v. Everhart*, 494 U.S. 83, 88-89, 110 S.Ct. 960, 963-65, 108 L.Ed.2d 72 (1990). We do not dispute that the dissent's interpretation of § 104(a)(2) is reasonable, only that it is compelled.

[5] The Tax Court, however, continues to hold that punitive damages are excludable, *Horton v. Commissioner*, 100 T.C. 93, 1993 WL 28557 (1993), *appeal pending*, 93-1929 (6th Cir.). We find the *Horton* dissent's arguments more persuasive than the majority's.

fore does not affect the Hawkinses' award, the Hawkinses nonetheless contend that we should read the 1989 version of § 104(a)(2) in light of this amendment. According to the Hawkinses, Congress's decision to amend the exclusion to exempt punitive damages received in non-personal injury cases implies that, under the previous version of § 104(a), such punitive damages were excludable—otherwise Congress would not have amended the statute.

We disagree. Congress may amend a statute simply to clarify existing law, to correct a misinterpretation, or to overrule wrongly decided cases. Thus, an amendment to a statute does not necessarily indicate that the unamended statute meant the opposite. Moreover, as the Supreme Court has emphasized, "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States v. Price,* 361 U.S. 304, 313, 80 S.Ct. 326, 332, 4 L.Ed.2d 334 (1961); *see also United States v. Texas,* —— U.S. ——, ——, 118 S.Ct. 1631, 1685 n. 4, 123 L.Ed.2d 245 (1993). The interpretive value of an amendment to a statute is particularly dubious where, as here, the amendment was enacted long after the original provision. *Rainwater v. United States,* 356 U.S. 590, 593, 78 S.Ct. 946, 948-49, 2 L.Ed.2d 996 (1958). At the time of the proposed amendment, several cases had recently held that § 104(a)(2) excludes damages recovered in cases involving employment discrimination and injury to reputation, *Threlkeld,* 848 F.2d at 83-84; *Roemer,* 716 F.2d at 700, and some had even held that punitive damages awarded in such cases are excludable. *Miller,* 93 T.C. 330, 1989 WL 104238 (1989), *rev'd,* 914 F.2d 586 (4th Cir.1990); *Roemer,* 716 F.2d at 700 (relying on a 1975 Revenue Ruling which has since been overruled). That Congress elected to overrule such cases does not prove that, prior to Congress's action, the statute meant the opposite.[6] Rather, Congress may have amended the

[6] In fact, the legislative history of the 1989 amendments indicates that Congress was not concerned with punitive damages, but with

law simply to clarify existing law, or to overrule these recently decided cases.[7]

Thus, neither § 104(a)(2)'s plain language, interpretive case law, or recent amendments indicate whether noncompensatory punitive damages such as the Hawkinses' are excludable. We therefore "look not only to the particular statutory language, but to the design of the statute as a whole and to its object and policy." *Crandon v. United States,* 494 U.S. 152, 158, 110 S.Ct. 997, 1001, 108 L.Ed.2d 132 (1990).

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non-physical injury cases. The original House of Representatives bill would have made all damages received on account of non-physical injuries fully taxable. H.R.Rep. No. 101-247, 101st Cong., 1st Sess. at 1354-55, *reprinted in* 1989 U.S.C.C.A.N. at 1906, 2824-25. The decision to address only punitive damages was a compromise reached after the Senate declined to pass the House bill. H.R.Conf.Rep. No. 101-386, 101st Cong., 1st Sess. at 623, *reprinted in* 1989 U.S.C.C.A.N. at 3225-26. Even if the amendments indicate that, at the time Congress was debating the issue, it thought that § 104(a)(2) applied to punitive as well as compensatory damages; they do not indicate that Congress gleaned the true intent of previous Congresses, only that Congress was aware that courts had recently so interpreted the section.

[7] The dissent correctly points out, of course, that Congress probably did not intend to broaden § 104(a)(2) and, as currently drafted, the statute may imply that punitive damages in physical injury cases are excludable. However, we do not believe that the only consistent explanation of these facts is that before 1989 all punitive damages received in personal injury cases were excludable from gross income. Rather, even if the 1989 amendment makes punitive damages received in physical injury cases excludable, this implication could be inadvertent. Or, since Congress simply did not address punitive damages received in physical injury cases and was concerned primarily with non-physical injury cases, it may have been "deferring to the courts on this issue." Dodge, *Taxes and Torts,* 77 Cornell L.Rev. No. 1, 143 & n. 4 (1992). Given our belief that excluding punitive damages is inconsistent with § 104(a)(2)'s title and purpose, we doubt that Congress intended to exclude any noncompensatory punitive damages. However, we express no opinion on the excludability of punitive damages received after 1989 in physical injury cases, as the issue is not before us. Like the dissent, we hope that Congress will shortly clear up the issue.

B.

Both § 104's title, "Compensation for Sickness and Injury," and its history suggest that § 104(a)(2) was enacted to exclude damages which compensate a taxpayer for injuries. *See, e.g.*, S.Rep. No. 97-646, 97th Cong., 2d Sess., *reprinted in* 1982 U.S.C.C.A.N. 4580, 4582 (describing § 104 as excluding certain types of compensation payments). We have previously recognized that "[d]amages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights—because, in effect, they restore a loss to capital." *Starrels v. Commissioner*, 304 F.2d 574, 576 (9th Cir.1962); *see also* 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶ 13.1.4 (1981) ("The rationale for § 104(a)(2) . . . is presumably that the recovery does not generate a gain or profit but only makes the taxpayer whole by compensating for a loss.").

This rationale justifies excluding the Hawkinses' compensatory damages. It also justifies excluding damages awards which purport *both* to compensate and to punish—such as the liquidated damages awarded in age discrimination cases. *See Miller*, 914 F.2d at 591 (distinguishing between punitive damages which serve *no* compensatory purpose and liquidated damages which serve both a deterrent and compensatory purpose); *Bennett v. United States*, 30 Fed.Cl. 396, 401 (1994) (in contrast to exclusively noncompensatory punitive damages, ADEA liquidated damages have a compensatory purpose and are therefore excludable); *Downey v. Commissioner*, 100 T.C. 634, 1993 WL 231740 (1993) (ADEA liquidated damages, which serve both to compensate for intangible injuries and to punish, are excludable); cf. *Threlkeld*, 848 F.2d at 84 (In a defamation suit alleging injury to reputation, "[a]ll income in compensation of that injury is excludable under § 104(a)(2)").

However, purely punitive awards, such as the Hawkinses', "are not intended to compensate the injured party, but rather to punish the tort-feasor whose wrongful action was intentional or malicious, and to deter him and others from similar extreme conduct." *City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 266, 101 S.Ct. 2748, 2759, 69 L.Ed.2d 616 (1981); *see also International Bhd. of Elec. Workers v. Foust*, 442 U.S. 42, 48, 99 S.Ct. 2121, 2125-26, 60 L.Ed.2d 698 (1979) ("Punitive damages are not compensation for injury. Instead, they are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence.") (internal quotations and citations omitted).

The Hawkinses do not contend that their punitive award has any compensatory purpose whatsoever. They concede that the $15,000 compensatory damage award completely covers their actual injuries, including the two-week deprivation of the family car, their out-of-pocket losses totalling less than $1,000, and their emotional distress. The additional $3.5 million in punitives were awarded not because the *Hawkinses* had suffered severe injuries but because Allstate's conduct had injured numerous *other* people. *Hawkins*, 733 P.2d at 1084-85 (upholding the award because of Allstate's wealth, pattern of similar misconduct, and the potential harm to innumerable claimants).

Whatever combination of policy or administrative convenience justifies giving the entire proceeds of Allstate's alleged bad faith to the Hawkinses—rather than distributing it among Allstate's other victims or donating it to the most deserving charity—the rationale (if any) has nothing to do with restoration of lost capital. The $3.5 million does not compensate the Hawkinses for any injury, economic, intangible or otherwise. It is a pure windfall, as much an accession to wealth as a successful lottery ticket or a game show winnings. The Hawkinses have not been made whole; they have won the litigation lottery.

In such circumstances, the restoration of capital rationale underlying § 104(a) is simply inapplicable. We see no valid reason to exempt a pure gain such as the Hawkinses' punitive award from taxation, and we doubt that Congress intended such a result.[8] Rather, construing § 104(a)(2) narrowly in favor of taxation, as all exemptions must be construed, *United States v. Centennial Savs. Bank*, 499 U.S. 573, 583-84, 111 S.Ct. 1512, 1518-19, 113 L.Ed.2d 608 (1991); *Commissioner v. Jacobson*, 336 U.S. 28, 69 S.Ct. 358, 93 L.Ed. 477 (1949), we find that the exemption does not apply to punitive damages which bear no relationship to actual injuries, do not even purport to compensate the victim for actual losses, and cannot rationally be characterized as anything but a windfall. Such awards are not received "on account of" personal injuries.

The judgment of the district court is REVERSED and the case is REMANDED to the district court with instructions to enter judgment in favor of the government.

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[8] *See also Reese*, 24 F.3d at 231 (emphasizing that all of § 104(a)'s other enumerated exemptions "encompass only the replacement of losses resulting from injury or sickness"); *Miller*, 914 F.2d at 590 (extending § 104(a)(2) to "situations in which a plaintiff's damages do not serve to make a plaintiff whole . . . runs afoul of the statute's purpose.").

TROTT, Circuit Judge, dissenting:

Attempting to provide some coherence to this middled area of the law, the majority offers the following principle: damages are excludable from gross income under § 104(a)(2) if they constitute a restoration of capital. Because punitive damages are designed to punish the tortfeasor, not compensate the injured party, the majority concludes punitive damages are taxable. Although I agree that the majority's restoration of capital rule may make sense as a matter of policy, I don't think the text of § 104(a)(2), its legislative history, or the case law can be squared with the majority's interpretation.

A. Section 104(a)(2) provides that gross income does not include "the amount of *any damages* received . . . on account of personal injuries or sickness." (emphasis added). As the Tax Court observed, "any damages" suggests "all damages." *Miller v. Commissioner,* 93 T.C. 330, 338, 1989 WL 104238 (1989), *rev'd,* 914 F.2d 586 (4th Cir.1990); *see also Horton v. Commissioner,* 100 T.C. 93, 95, 1993 WL 28557 (1993). If Congress intended to exclude only compensatory damages from gross income, it certainly could have made that distinction explicit. The language of § 104(a)(2) simply does not permit a distinction between compensatory and punitive damages.

The majority, joining the Fourth and Federal Circuits, asserts the provision is ambiguous. *See Reese v. United States,* 24 F.3d 228 (Fed.Cir.1994); *Miller,* 914 F.2d at 589-90. I disagree. The majority claims: " 'Damages received on account of personal injury' could mean all damages received in a personal injury lawsuit, or, it could mean only those damages which purport to compensate the taxpayer for such injuries." But the majority passes over the fact that the word "any" precedes "damages." I think the Tax Court's conclusion that the language was unambiguous, permitting no distinction between compensatory and punitive damages, is a sound construction of the statute. *See Horton,* 100 T.C. at 95, 1993 WL 28557; *Miller,* 98 T.C. at 338, 1989 WL 104238.

The Tax Court decisions were nearly unanimous—*Miller* was a 15 to 2 decision and *Horton* was a 16 to 3 decision. Although we review the Tax Court's conclusions of law de novo, we should proceed cautiously when reversing a position the Tax Court carefully considered and accepted by an overwhelming majority on two separate occasions. Similarly, the majority lightly glosses over our decision in *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir.1983). In *Roemer*, we held punitive damages were excludable "where there has been a personal injury." *Id.* at 700. Under *Roemer*, taxpayers clearly win this case. The majority contends *Roemer* no longer controls because the court relied upon a 1975 Revenue Ruling which has since been overruled. Presumably, however, the Roemer court independently reviewed the text of the statute and did not blindly follow the Internal Revenue Service's pronouncements on the subject. Furthermore, the Service's flip-flop on the issue, *compare* Rev.Rul. 75-45, 1975-1 C.B. 47 (punitive damages not taxable) *with* Rev.Rul. 84-108, 1984-2 C.B. 32 (punitive damages taxable), undermines its claim that *now* it really knows what § 104(a)(2) means.

The majority believes § 104(a)(2) requires the taxpayer to prove both (1) the damages were recovered in a tort-like suit and (2) the damages were received on account of personal injury. The majority then concludes punitive damages are not received on account of personal injury because they do not compensate for personal injury, nor do they bear any relationship to actual injuries. Most jurisdictions, however, require some amount of actual damage before punitive damages are available. *Miller*, 93 T.C. at 339, 1989 WL 104238. I think it's reasonable to conclude that punitive damages are received on account of personal injury because punitive damages are not available unless a personal injury has occurred. Therefore, even under the majority's test, punitive damages in a personal injury lawsuit should be excludable under § 104(a)(2).

B. Instead of the majority's two-part test, however, I would adopt the Tax Court's approach:

> The beginning and end of the inquiry should be whether the damages were paid on account of "personal injuries." This inquiry is answered by determining the nature of the underlying claim. Once the nature of the underlying claim is established as one for personal injury, any damages received on account of that claim, including punitive damages, are excludable.

*Horton*, 100 T.C. at 96, 1993 WL 28557.

Like the Tax Court, I believe the Supreme Court's opinion in *United States v. Burke*, —— U.S. ——, 112 S.Ct. 1867, 119 L.Ed.2d 34 (1992), essentially adopted this method of analysis. The Sixth Circuit had held in *Burke* that

> *Threlkeld* [*v. Commissioner*, 87 T.C. 1294, 1986 WL 22061 (1986), aff'd 848 F.2d 81 (6th Cir. 1988)] and its progeny require that for the purposes of § 104(a)(2), this court determine whether the injury is personal and the claim resulting in the damages is tort-like in nature. If the answer is in the affirmative, then that is "the beginning and end of the inquiry." The damages resulting from such a claim are fully excludable under § 104(a)(2).

*Burke v. United States*, 929 F.2d 1119, 1123 (6th Cir. 1991). Although the Supreme Court reversed the Sixth Circuit's holding that Title VII claims were tort-like in nature, the Court expressly adopted the Sixth Circuit's focus on the nature of the underlying claim: "We thus agree with the Court of Appeals' analysis insofar as it focused, for purposes of § 104(a)(2), on the nature of the claim underlying . . . [the taxpayers'] damages award." *Burke*, —— U.S. at ——, 112 S.Ct. at 1872. The majority tries to finesse this reasoning by noting the *Burke* Court did not directly consider whether punitive damages were excludable. But the impart of the Court's analysis is clear. The focus should be on the nature of the under-

lying claim. The *Burke* Court did not mention any additional requirements for exclusion under § 104(a)(2).[1]

There is also another way in which *Burke* supports the conclusion that punitive damages are excludable from gross income. The Court described the availability of punitive damages as one of the indicia of traditional tort liability. Id. The Court then relied upon the unavailability of punitive damages in a Title VII case to hold that Title VII does not redress a tort-like personal injury. *Id.* at ——, 112 S.Ct. at 1873. The Supreme Court stated that "the concept of a 'tort' is inextricably bound up with remedies," including punitive damages. *Id.* at ——, 112 S.Ct. at 1872 n. 7. Because punitive damages are one of the primary indicia of a personal injury claim, I believe it follows that punitive damages are received "on account of personal injury." *Horton*, 100 T.C. at 99, 1993 WL 28557. To conclude otherwise, as the majority does, is to say that although the availability of punitive damages makes the claim tort-like, rendering the compensatory damages excludable under § 104(a)(2), the punitive damages themselves are unrelated to the personal injury and should be taxable. I am reluctant to reach such an illogical conclusion.

Because everyone agrees that the Hawkinses' bad-faith lawsuit against Allstate was a tort-type claim and that

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[1] The decision in *O'Gilvie v. United States*, 92-2 USTC ¶ 50,567, 1992 WL 223847 (D.Kan. 1992), construed *Burke* in a similar vein. In *O'Gilvie*, the district court originally held punitive damages in a wrongful death suit were not excludable from gross income, relying on the Fourth Circuit's decision in *Miller*. However, the district court reversed its decision upon reconsideration after *Burke*. The court stated:

> In our previous order, this court focused on the nature of the punitive damage award itself, rather than the nature of the underlying claim. In light of *Burke*, we believe our focus was misplaced. The Supreme Court's opinion makes clear that the proper inquiry for purposes of § 104(a)(2) is on the nature of the claim underlying the taxpayers' damages award.

*Id.* at 83, 974-73, 1992 WL 223847.

they suffered personal injury, I believe the punitive damages must be excludable.

C. The 1989 amendment to § 104 further supports my conclusion. The 1989 amendment provided that § 104 (a)(2) "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub.L. No. 101-239, § 7641, 108 Stat. 2106, 2379.[2] Thus, if the Hawkinses recovered punitive damages for their bad-faith insurance claim after 1989, the punitive damages would be taxable because their personal injuries were not physical. The Hawkinses contend, quite reasonably, that the amendment suggests *all* punitive damages received before 1989 are not taxable. The majority rejects this argument. The majority believes that just because Congress in 1989 thought punitive damages were excluded from taxation by § 104(a)(2) doesn't necessarily mean that Congress in 1918 intended § 104(a)(2) to encompass punitive damages.

I agree Congress's interpretation in 1989 may not be dispositive, but it certainly is relevant. The majority's inability to harmonize the original statute with the amended statute troubles me because the majority's construction leads to peculiar results. I believe we must start with the premise that punitive damages received after 1989 in cases of physical injury or sickness will be excludable from gross income. *See Burke*, —— U.S. at ——, 112 S.Ct. at 1871 n. 6 ("Congress amended § 104 (a) to allow the exclusion of punitive damages only

[2] The 1989 amendment only applies to "amounts received after July 10, 1989, in taxable years ending after such date," unless the amounts were received "under any written binding agreement, court decree, or mediation award in effect on (or issued on or before) July 10, 1989." *Id.* Here, the Hawkinses apparently received payment during 1988, thus, the 1989 amendment does not literally apply. Nevertheless, any construction of § 104(a)(2) should take into account Congress's latest interpretation and modification of the statutory scheme.

in cases involving 'physical injury or physical sickness.' ").[3] My position offers a consistent explanation of both the pre-1989 and post-1989 law. Before 1989, all punitive damages received in personal injury cases were excludable from gross income. After Congress's narrowing of the exclusion in 1989, only punitive damages received in personal injury cases involving physical injury or sickness were excludable.

By contrast, the majority is unable to offer a satisfactory explanation of the 1989 amendment. The majority suggests that *all* punitive damages, both before and after 1989, must be taxable. After all, punitive damages are just as much of a windfall in a physical injury case as a nonphysical injury case. In both cases, the punitive damage award does not compensate the injured party for any loss—rather it's designed to punish or deter the tortfeasor. Unfortunately, this conclusion means that Congress's 1989 amendment to § 104 had no effect because punitive damages were already taxable! Moreover, if Congress wanted to clarify that all punitive damages were taxable, why did the amendment create a distinction between physical and nonphysical injury cases?

One way to avoid the absurdity of construing the 1989 amendment as meaningless would be to argue that the amendment made punitive damages awarded in physical injury cases after 1989 not taxable when previously they were taxable. But then, instead of narrowing the § 104 (a)(2) exclusion, one would have to conclude that Congress actually intended its 1989 amendment to broaden

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[3] Commentators overwhelmingly agree with this interpretation of the 1989 amendment. *See* Arthur W. Andrews, *The Taxation of Title VII Victims After the Civil Rights Act of 1991*, 46 Tax Law, 755, 766 (1993); Mark Wright Cochran, *1989 Tax Act Compounds Confusion over Tax Status of Personal Injury Damages*, 49 Tax Notes 1565, 1567 (1990); Margaret Henning, *Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries*, 45 Tax Law, 783, 801 (1992); David G. Jaeger, *Taxation of Punitive Damage Awards: The Continuing Controversy*, 57 Tax Notes 109, 114 (1992).

the § 104(a)(2) exclusion. I don't think that interpretation is tenable. If Congress wanted to broaden the exclusion, it could simply have amended § 104 to read: Punitive damages in cases involving physical injury or sickness are excludable. But Congress didn't do that.[4]

I understand this case does not involve a post-1989 punitive damages award. However, I think it's important that we consider the effect of our analysis on subsequent cases, especially when all future cases will be decided under the amended statute. The rule the majority announces—damages representing a windfall are taxable—will undoubtedly be cited in support of the proposition that *all* punitive damages are taxable. This court will then have to chose between rendering the 1989 amendment meaningless or improperly construing the amendment as expanding the § 104 exclusion. My interpretation of § 104(a)(2) avoids that dilemma.

D. The majority tries to rationalize the § 104(a)(2) exclusion in terms of a return of capital theory. I wish it were that simple. The majority's rationale makes a lot more sense than the scheme Congress has devised, but we're bound by the statute and the case law.

The return of capital theory has been widely criticized as a means of explaining the § 104(a)(2) exclusion. *See, e.g., Downey v. Commissioner*, 97 T.C. 150, 159, 1991 WL 140900 (1991), *supplemental opinion*, 100 T.C. 634, 1993 WL 231740 (1993); *Cochran, supra*, at

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[4] As one commentator observed:

> To argue that unamended section 104 does not exclude any punitive damages would mean that the amendment has the effect of broadening the statute to cover punitive damages received for physical injury. If this had been Congress' intent, the amendment would likely have been drafted in a positive manner and stated that punitive damages received for physical injury are excludable from income. The legislative history behind the amendment clearly shows that the intent was to limit the scope of the language found in section 104.

Jaeger, *supra*, at 114.

1573; *Henning, supra*, at 796; Robert J. Henry, *Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries,* 23 Hous.L.Rev. 701, 725 (1986). For example, suppose the Hawkinses are injured in an automobile accident and, as a result, can't work for two weeks. If they receive compensatory damages equal to two weeks' lost earnings, the damages would clearly be excludable under § 104(a)(2). But haven't they been made more than whole? After all, if they had worked during those two weeks, they would have been required to pay taxes on their wages. But because of the injury, they received more money than if they had worked. Thus, compensatory damages, like punitive damages, can represent a windfall in addition to a return of capital. Furthermore, it's impossible to explain, based on the return of capital theory, why punitive damages in physical injury cases after 1989 are not taxable.

The return of capital theory is closely related to the concept of basis in tax law. If I buy a property for $100 and sell it for $150, my $50 gain is taxable. My $100 basis, or return of capital, is not. See 26 U.S.C. §§ 1001, 1011-1012. But what is a person's basis in his or her own body? Should we keep track of how much money is spent on improving the human body to calculate each person's basis? Obviously, this would be impractical, but how else can we separate return of capital from windfall? *See generally* J. Martin Burke & Michael K. Friel, *Tax Treatment of Employment-Related Personal Injury Awards: The Need for Limits,* 50 Mont.L.Rev. 13, 42 (1989).

The majority tries to impose some logic and commonsense on § 104(a)(2). Despite their efforts, I fear they might sow more confusion than clarification. Congress should straighten out this mess, but until they do, we must do our best to apply the statute as it is written and as we believe Congress intended. We cannot contradict the statute's plain language in an effort to impose order in the sometimes-chaotic world of the tax code.

## APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT ARIZONA

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Case No. Civ. 91-1519 PHX WPC

JACK R. HAWKINS, CYNTHIA J. HAWKINS, husband & wife,
*Plaintiffs,*

v.

UNITED STATES OF AMERICA,
*Defendant.*

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## MEMORANDUM AND ORDER

[Filed February 16, 1993]

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## MEMORANDUM AND ORDER

COPPLE, District Judge: Currently pending before the Court is Defendant United States of America's motion for summary judgment and plaintiffs' cross-motion for summary judgment. The parties agree that this Court must resolve the single issue of whether the punitive damages received by plaintiffs in 1988 from Allstate Insurance Company based upon their bad faith litigation, and which were awarded on account of the resulting personal injuries suffered by the Hawkins, are excludable from gross income pursuant to sec. 104(a)(2) of the Internal Revenue Code, 26 U.S.C., Treas. Reg. sec. 1.104-1(c), and case law. This Court concludes that the punitive damage award is excludable from gross income pursuant to the clear language of the Internal Revenue Code and the

applicable Treasury Regulations and after reviewing pertinent case law.

The relevant statute provides that gross income does not include "any damages received . . . on account of personl injuries or sickness." Because personal injuries were a requisite for the award of punitive damages in the underlying action, the plain language of the statute includes both compensatory and punitive damages as excludable from gross income for tax purposes.

Additionally, courts which have analyzed the basis for sec. 104(a)(2) and its applicability to personal injuries have concluded that the exclusion from income provided by the statute depends on the nature of the underlying claim and not the consequences of the injury. See, *e.g.*, *Burke v. United States* [92-1 USTC ¶ 50,254], 60 U.S.L.W. 4404 (May 26, 1992); *Redfield v. Insurance Company of North America* [91-2 USTC ¶ 50,385], 940 F.2d 542 (9th Cir. 1991).

IT IS THEREFORE ORDERED:

(1) Defendant's motion for summary judgment is hereby denied.

(2) Plaintiffs' cross-motion for summary judgment is hereby granted. The Clerk shall enter judgment accordingly.

## JUDGMENT

This action came on for consideration before the Court, the Honorable William P. Copple, United States District Judge, presiding, and the issues having been duly considered and a decision having been duly rendered,

IT IS ORDERED AND ADJUDGED that judgment is hereby entered in favor of the plaintiffs and against the defendant. This judgment is in accordance with this Court's order dated February 16, 1993, which concludes that the punitive damage award is excludable from gross income pursuant to the Internal Revenue Code and the applicable Treasury Regulations, and directs entry of judgment accordingly by the Clerk of the Court.

## APPENDIX C

[Filed Sep. 13, 1994]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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No. 93-15828

D.C. No. CIV-91-1519 WPC

JACK R. HAWKINS, CYNTHIA J. HAWKINS,
husband and wife,
*Plaintiffs-Appellees,*

v.

UNITED STATES OF AMERICA,
*Defendant-Appellant.*

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ORDER

Before: GOODWIN, FERGUSON and TROTT, Circuit Judges.

A majority of the panel has voted to deny the petition for rehearing. Judges Goodwin and Ferguson recommend rejection of the suggestion for rehearing en banc. Judge Trott would grant petition for rehearing and accept the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

**APPENDIX D**

[Filed Sep. 19, 1994]

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1994

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No. 94-500

COMMISSIONER OF INTERNAL REVENUE,
*Petitioner*

v.

ERICE E. and HELEN B. SCHLEIER

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PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Whether back pay and liquidated damages received in settlement of litigation under the Age Discrimination in Employment Act of 1967 are excluded from gross income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries or sickness" (26 U.S.C. 104(a)(2)).

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

## OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 68a-69a) is unpublished, but the decision is noted at 26 F.3d 1119 (Table). The opinion of the Tax Court (App., *infra*, 64a-65a) is unreported.

## JURISDICTION

The judgment of the court of appeals was entered on June 21, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), provides in relevant part:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.

2. Section 104(a) of the Internal Revenue Code, 26 U.S.C. 104(a), provides in relevant part:

> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—
>
> * * * *
>
> (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness
>
> * * * *

3. Section 1.104-1(c) of the Treasury Regulations, 26 C.F.R. 1.104-1(c), provides:

> Section 104(a)(2) [of the Internal Revenue Code] excludes from gross income the amount of any damages received (whether by suit or agreement) on

account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

## STATEMENT

1. Respondent Erich E. Schleier is a former employee of United Airlines, Inc.[1] Pursuant to an established policy of United Airlines, respondent's employment was terminated when he reached the age of sixty (Tax Ct. Pet. 2-3). Respondent thereafter filed a complaint in federal district court alleging that his termination violated the Age Discrimination in Employment Act of 1967 (ADEA), which (with exceptions not relevant here) makes it "unlawful for an employer * * * to discharge any individual * * * because of such individual's age" (29 U.S.C. 623(a)(1)). The remedies for an unlawful discharge under the ADEA include reinstatement, back pay, injunctive and declaratory relief and attorneys fees. See 29 U.S.C. 626(b); 29 U.S.C. 216(b), 217. The ADEA also authorizes an additional award of "liquidated damages" in an amount equal to the backpay award "in cases of willful violations" of that Act. 29 U.S.C. 626(b).

Respondent's complaint was consolidated within a class action suit against United Airlines. On June 30, 1986, the class action was settled under an agreement providing for monetary payments to the class members. One half of the settlement payment was attributed to "back pay"; the other half of the payment was attributed to "liquidated damages." As a result of the settlement, respondent received "back pay" of $72.814.50 and "liquidated damages" in the same amount (Tax Ct. Pet. 4-5).

[1] Respondent's wife Helen is a party to this case solely because the couple filed a joint income tax return during the year in question.

Respondent reported the "back pay" as income on his 1986 tax return. He did not, however, report the "liquidated damages" that he received under the settlement. The Commissioner of Internal Revenue issued a notice of deficiency to respondent, asserting that the liquidated damages were improperly excluded from his income, resulting in a deficiency of $35,918.50 in respondent's income tax for 1986 (Tax Ct. Pet. 2).

2. Respondent commenced this case in Tax Court to obtain a redetermination of the asserted deficiency. The petition alleged that the "liquidated damages" portion of the settlement payment was properly excluded from gross income under Section 104(a)(2) of the Internal Revenue Code, which provides that "gross income does not include" (26 U.S.C. 104(a)(2))

> the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

The petition further alleged that the "back pay" portion of the settlement payment, which had been reported as income on respondent's 1986 return, was also excludable from gross income under Section 104(a)(2). Respondent therefore sought a determination of overpayment (as authorized by 26 U.S.C. 6512(b)).

a. Proceedings on respondent's case were deferred pending the Tax Court's disposition of the lead case arising out of the United Airlines class action settlement, *Downey v. Commissioner*, 97 T.C. 150 (1991), supplemental opinion, 100 T.C. 634 (1993), rev'd, No. 93-3763 (7th Cir. Aug. 30, 1994).

In its original opinion in *Downey* (App., *infra*, 1a-39a), the Tax Court (in a reviewed opinion with six judges dissenting in part) held that back pay and liquidated damages received under the ADEA are excludable from gross income under Section 104(a)(2). With respect to back

pay, the Tax Court expressly adopted (App., *infra*, 21a-24a) the reasoning of *Rickel* v. *Commissioner*, 900 F.2d 655 (3d Cir. 1990), and *Pistillo* v. *Commissioner*, 912 F.2d 145 (6th Cir. 1990), which held that back pay awards under the ADEA are excludable from gross income because (i) an ADEA suit alleges a violation of a duty that arises by operation of a statute and not by virtue of a contract and (ii) statutes addressing discrimination in the workplace had been characterized by other courts as involving personal injury. 900 F.2d at 662-663; 912 F.2d at 149-150.

With respect to liquidated damages, the Tax Court in *Downey* rejected the Commissioner's contention that ADEA liquidated damages—like punitive damages—are paid because of the employer's willful misconduct, rather than "on account of personal injuries" (26 U.S.C. 104 (a)(2)) to the employee, and are therefore not excluded from gross income under the plain language of the statute. App., *infra*, 26a. See *Commissioner* v. *Miller*, 914 F.2d 586, 589-591 (4th Cir. 1990). The Tax Court held that, while ADEA liquidated damages serve a punitive purpose, these damages, when viewed from the victim's perspective, represent compensation for nonpecuniary losses. App., *infra*, 26a-29a.

b. The Tax Court withheld entry of its final decision in *Downey* pending this Court's decision in *United States* v. *Burke*, 112 S. Ct. 1867 (1992). In *Burke*, this Court held that back pay awards received in settlement of litigation under the pre-1991 version of Title VII of the Civil Rights Act of 1964 are not excludable from gross income under Section 104(a)(2). In reaching that conclusion, the Court emphasized that a statute "whose sole remedial focus is the award of backwages" (112 S. Ct. at 1874) does not represent a tort-like remedy of a personal injury but instead represents redress for "legal injuries of an economic character" (*id.* at 1873, quoting *Albemarle Paper Co.* v. *Moody*, 422 U.S. 405, 418 (1975)). The Court

concluded that a backpay remedy that redresses an economic injury is "not excludable from gross income as 'damages received . . . on account of personal injuries' under § 104(a)(2)." 112 S. Ct. at 1874.

After this Court issued its decision in *Burke*, the Tax Court granted the Commissioner's motion for reconsideration of the *Downey* decision. In a supplemental opinion in *Downey* (with several separate opinions), the Tax Court emphasized that one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the victim, as well as punitive damages when the defendant's misconduct was intentional or reckless. App., *infra*, 42a. The Tax Court observed that, in contrast with the pre-1991 version of Title VII involved in *Burke* (which limited the available remedies to back pay and equitable relief, see 112 S. Ct. at 1872-1874 & nn. 8, 12), the ADEA provides "a range of remedies, including both unpaid wages and 'liquidated damages.'" App., *infra*, 44a. The Tax Court concluded that the ADEA "evidences a tort-like conception of injury and remedy" because "liquidated damages" under the ADEA compensate the victim of age discrimination for nonpecuniary losses and also serve a deterrent or punitive purpose. App., *infra*, 45a. The Tax Court therefore reaffirmed its prior holding in *Downey* that all damages received in ADEA litigation are excludable from gross income under Section 104(a)(2). App., *infra*, 45a.

c. On July 7, 1993, the Tax Court entered an order in the present case granting respondent's motion for summary judgment based on the court's ruling in *Downey*. App., *infra*, 64a-65a.

3. The Commissioner appealed from the Tax Court's rulings in this case and in *Downey*. While these appeals were pending, the Fifth Circuit endorsed and adopted the Tax Court's decision in *Downey* in the course of addressing a damages issue in private ADEA litigation in which the United States was not a party and did not participate.

*Purcell v. Seguin State Bank & Trust Co.*, 999 F.2d 950, 961 (1993).[2] The court in *Purcell* agreed with the Tax Court's reasoning that "ADEA claims are tort-like and that an entire ADEA award is nontaxable." *Ibid.*

a. Because the Fifth Circuit had recently endorsed the Tax Court's *Downey* decision in *Purcell*, the Commissioner filed a suggestion that the appeal in respondent's case be heard *en banc*. The Fifth Circuit rejected that suggestion (App., *infra*, 67a). The three-judge panel assigned to this case then entered a decision in favor of respondent solely on the authority of *Purcell* (App., *infra*, 68a-69a).

b. On the Commissioner's appeal from the *Downey* decision, the Seventh Circuit reversed the Tax Court, holding that ADEA backpay and liquidated damages awards are *not* excluded from income under Section 104(a)(2) (App., *infra*, 70a-77a). The Seventh Circuit reasoned that (*id.* at 6a):

> Burke stands for the proposition that a federal anti-discrimination statute must provide compensatory damages for intangible elements of personal injury (such as pain and suffering, emotional distress, or personal humiliation) to constitute a tort-type personal injury and receive tax exempt treatment under sec. 104(a)(2).

The court noted that the only damages remedies under the ADEA were back pay and liquidated damages and that neither of those remedies "compensate for the intangible elements of a personal injury" (App., *infra*, 77a). Because the limited remedies available under the ADEA thus lack "an essential element of a tort-type claim," the

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[2] In *Purcell*, the court concluded that an addition to an ADEA backpay award to take account of the employee's income tax liabilities would be improper because, under the Tax Court's ruling in *Downey*, the ADEA award would not be subject to tax under Section 104(a)(2) of the Code. See 999 F.2d at 961.

Seventh Circuit concluded that, under this Court's analysis in *Burke*, the damages awarded under that statute "cannot be excluded from taxation under sec. 104(a)(2)" (App., *infra*, 77a).

c. In an appeal involving a different party to the United Airlines settlement, the Ninth Circuit affirmed a Tax Court decision based upon *Downey*. *Schmitz* v. *Commissioner*, No. 93-70960 (Aug. 30, 1994) (App., *infra*, 78a-96a). In *Schmitz*, the Ninth Circuit agreed with the Tax Court that the ADEA represents a "tort-like" cause of action, reasoning that the "ADEA's liquidated damages provision, as well as its provision for jury trials, distinguishes ADEA from the statute discussed in *Burke*" (*id.* at 84a). The court of appeals concluded that ADEA recoveries were therefore excluded from tax under Section 104(a)(2).

In *Schmitz*, the Ninth Circuit also rejected the Commissioner's additional contention that, if ADEA represents a "tort-type" recovery for a personal injury, the liquidated damages component of that recovery would be subject to tax in any event because it does not represent an award "on account of personal injuries" (26 U.S.C. 104(a)(2)) but is instead a penalty "on account of" the employer's willful misconduct. App., *infra*, 85a-91a. The court stated that liquidated damages under the ADEA are excluded from tax under Section 104(a)(2) because they are designed "to compensate victims for damages which are too obscure and difficult to prove" (App., *infra*, 87a).

## REASONS FOR GRANTING THE PETITION

The Fifth, Seventh and Ninth Circuits have issued conflicting decisions on review of the same Tax Court opinion. The Fifth and Ninth Circuits, in *Commissioner* v. *Schleier* and *Schmitz* v. *Commissioner*, held that the Tax Court correctly concluded in *Downey* that backpay and liquidated damages awards under the ADEA are to be excluded from gross income as "damages received * * *

on account of personal injuries" under Section 104(a)(2) of the Internal Revenue Code (App., *infra*, 69a, 91a (respectively)). In *Downey* v. *Commisioner*, however, the Seventh Circuit reached exactly the opposite conclusion (App., *infra*, 77a). In reaching these conflicting results, the courts of appeals relied on different understandings of the interpretation of Section 104(a)(2) set forth in this Court's decision in *United States* v. *Burke*, 112 S. Ct. 1867 (1992). Absent further review by this Court, these conflicting understandings of *Burke* by the courts of appeals will result in disparate tax treatment of otherwise identically situated taxpayers (including the many parties who participated in the same class action settlement of the United Airlines ADEA litigation).[3]

The proper treatment of ADEA recoveries, as well as other types of statutory recoveries, under Section 104(a)(2) of the Internal Revenue Code represents a recurring question of substantial administrative importance. The issues addressed in this case affect many thousands of individuals who have received, or will receive in the future, damage awards under the ADEA and other state and federal statutory schemes.

1. Section 104(a)(2) of the Code provides that gross income does not include "the amount of any damages received (whether by suit or agreement * * *) on account of personal injuries or sickness." 26 U.S.C. 104(a)(2). By regulation, the Treasury has defined the term "damages received" within this statute to mean "an amount received * * * through prosecution of a legal suit or action based upon tort or tort type rights or through a settlement agreement entered into in lieu of such prosecution." 26 C.F.R. 1.104-1(c). Under the statute, as amplified by the regulation, a recovery may be excluded from gross income only when it both (i) was received through prosecution

[3] Additional appeals in cases governed by the Tax Court's *Downey* decision, involving other parties to the United Airlines settlement, are currently pending in the Tenth and Eleventh Circuits.

or settlement of a suit or action based upon tort or tort-type rights (*ibid.*) and (ii) was received "on account of personal injuries or sickness" (26 U.S.C. 104(a)(2)).[4]

In *United States* v. *Burke*, 112 S. Ct. 1867 (1992), this Court applied these principles to conclude that back pay received under the pre-1991 version of Title VII of the

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[4] In a concurring opinion in *United States* v. *Burke*, Justice Scalia noted that these two requirements are logically distinct. 112 S. Ct. at 1875 n.1. Justice Scalia indicated, however, that he understood an IRS ruling and the government's brief in *Burke* to have treated the two requirements as one. *Ibid.* We respectfully disagree with that conclusion. The brief for the United States in *Burke* (91-42 U.S. Br. at 24) states:

> Even if Title VII could properly be regarded as involving a "tort type" right within the meaning if the regulation, back pay would nonetheless not be excludable under Section 104 (a)(2) because the injury suffered by respondents (and the injury for which they were compensated under Title VII) was not a personal injury, but rather an injury to their economic interests.

The government's brief in *Burke* further noted that (*id.* at 23 n.17):

> The exclusion for damages received "on account of personal injuries" is not an exclusion for all tort damages. Many tort claims do not involve injuries to the person, but rather injuries to property or other economic interests, *e.g.*, claims for injuries to property, fraud, tortious interference with a contract, and trade libel. Although all "personal injuries" for purposes of Section 104(a)(2) involve tort or tort-like claims, not all tort or tort-like claims involve personal injuries.

The government's brief in *Burke* concluded that, even if Title VII were a "tort like" remedy, the award would not be excluded from income under Section 104(a)(2) because "the discrimination addressed by Title VII 'deals with legal injuries of an economic character.'" (91-42 U.S. Br. at 24, quoting *Albemarle Paper Co.* v. *Moody*, 422 U.S. 405, 418 (1975)). In concluding in *Burke* that backpay awards under the pre-1991 version of Title VII did not represent damages received on account of a personal injury, the Court similarly noted that "Title VII focuses on 'legal injuries of an economic character,' *see Albemarle Paper Co.* v. *Moody*, 422 U.S. 405, 418 * * * (1975)" (112 S. Ct. at 1873).

Civil Rights Act of 1964 was not excludable from gross income. The Court noted that Title VII's circumscribed remedial scheme, which was then limited to back pay and injunctive relief (see 112 S. Ct. at 1874 n.12), focused exclusively on the economic injury (lost wages) resulting from employment discrimination and provided no compensation for "traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages" (*id.* at 1873).[5] The limited remedy under that statute therefore did not constitute "damages received * * * on account of personal injuries" within the meaning of Section 104(a)(2). 112 S. Ct. at 1873-1874.[6]

Applying this Court's decision in *Burke*, the Seventh Circuit properly concluded in *Downey* v. *Commissioner* (App., *infra*, 77a) that back pay and liquidated damages received under the ADEA are not excludable from gross income under Section 104(a)(2). The ADEA, like the pre-1991 version of Title VII involved in *Burke*, does not

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[5] The availability of compensatory damages for intangible elements of personal injury such as pain and suffering and emotional distress is an essential characteristic of a personal injury tort action. See *Vicksburg & Meridian R.R.* v. *Putnam*, 118 U.S. 545, 554 (1886); 3 L. Frumer & M. Friedman, *Personal Injury* § 3.01, at 94 (1991); 2 S. Speiser, C. Krause & A. Gans, *The American Law of Torts* § 8:18, at 552 (1985). Awards for pain and suffering are estimated to account for 72% of damages in personal injury litigation. *Jones & Laughlin Steel Corp.* v. *Pfeifer*, 462 U.S. 523, 552 n.35 (1983).

[6] The Court's opinion in *Burke* did not resolve whether back pay received under a federal antidiscrimination statute could *ever* be excludable from gross income under Section 104(a)(2). The Internal Revenue Service concluded after *Burke*, however, that recoveries under statutory schemes (such as the post-1991 provisions of Title VII) that provide back pay along with remedies for "traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, [and] other consequential damages" (112 S. Ct. at 1873), are excluded from income by Section 104(a)(2). See Rev. Rul. 93-88, 1993-2 C.B. 61.

represent a tort-type action for a personal injury. The only difference between the remedial scheme provided by the pre-1991 version of Title VII and the remedial scheme provided by the ADEA is that employees may recover "liquidated damages" under the ADEA when—but only when—the employer has engaged in "willful violations" of the statute (29 U.S.C. 626(b)).[7] The ADEA does not provide compensation for "traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages" (*United States* v. *Burke*, 112 S. Ct. at 1873). See, *e.g.*, *Haskell* v. *Kaman Corp.*, 743 F.2d 113, 120-121 & n.2 (2d Cir. 1984). The ADEA thus does not provide a tort-type remedy for personal injuries. *See United States* v. *Burke*, 112 S. Ct. at 1873.[8]

Under the ADEA, as in *Burke*, the focus of the statutory backpay remedy is exclusively on the economic, rather than personal, injuries of the employee. Liquidated damages under the ADEA are also not available as compensation for personal injuries that a discharged employee may have incurred. Instead, liquidated damages under the ADEA (like many other types of statutory penalties) are available only when needed to punish the intentional wrongdoer for "willful violations" of the law (29 U.S.C. 626(b)). As the Seventh Circuit correctly observed in reversing the Tax Court's *Downey* decision, damages for "willful violations" of the law represent an enforcement

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[7] Federal employees may not recover liquidated damages under the ADEA. *Smith* v. *OPM*, 778 F.2d 258, 263 (5th Cir. 1985), cert. denied, 476 U.S. 1105 (1986).

[8] ADEA litigants are entitled to jury trials. *Lorillard* v. *Pons*, 434 U.S. 575 (1978). In *Burke*, the Court noted that jury trials were not available under the pre-1991 version of Title VII. See 112 S. Ct. at 1872. While the lack of a right to a jury trial may indicate that the remedy is *not* "tort-type" in nature (see *id.* at 1873), the availability of a jury trial does not indicate that the right *is* tort-type. As common law, jury trials were available for contract, as well as tort, claims.

penalty and "do not compensate for the intangible elements of a personal injury" (App., *infra*, 77a).[9] See also *Gertz* v. *Robert Welch, Inc.*, 418 U.S. 323, 350 (1974) (Punitive damages "are not compensation for injury. Instead, they are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence."). The ADEA remedy does not qualify for exclusion under Section 104(a)(2) because, although it redresses the economic injury of the victim of age discrimination, it provides no compensation for any associated or consequential personal injuries resulting from the discrimination.

The contrary holdings of the Fifth Circuit in the present case (App., *infra*, 69a) and of the Ninth Circuit in *Schmitz* v. *Commissioner* (App., *infra*, 91a) err in accepting the Tax Court's conclusion in *Downey* that the ADEA provides a "range of remedies" as compensation for non-economic, personal injuries (App., *infra*, 44a). Neither the award of back pay, nor the enforcement penalty for willful violations of the Act, compensates the victims of age discrimination for the "traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, [and] other consequential damages" (*United States* v. *Burke*, 112 S. Ct. at 1873).

2. Even if the ADEA were thought to represent a tort-type remedy for a personal injury, any liquidated damages awarded under that Act would not be excludable from gross income under Section 104(a)(2). When applicable, Section 104(a)(2) permits exclusion only of damages received "on account of" personal injuries (26 U.S.C. 104(a)(2)). As the Fourth Circuit concluded in *Commissioner* v. *Miller*, damages awarded as punishment of a wrongdoer, rather than as compensation for an injury,

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[9] Liquidated damages are not a tort remedy; they are an ordinary remedy for breach of contract. See *Rex Trailer Co.* v. *United States*, 350 U.S. 148, 151 (1956). The statute's use of the term "liquidated damages," however, does not obscure the fact that such damages, when awarded solely for "willful violations" of the Act, constitute an enforcement penalty.

are awarded "on account of" malice or willfulness, not "on account of" personal injury, 914 F.2d at 589-592. Accord, *Hawkins* v. *United States*, No. 93-15828 (9th Cir. July 19, 1994); *Reese* v. *United States*, 24 F.3d 228, 230-235 (Fed. Cir. 1994). Punitive damages and statutory penalties for "willful violations" of the law thus do not come within the literal terms of the exclusion from income provided by Section 104(a)(2).[10] That conclusion, which appears plain enough on the face of the statute, is also supported by the fundamental principle of statutory construction that exclusions from income are to be construed strictly in favor of the government. See *United States* v. *Burke*, 112 S. Ct. at 1878 (Souter, J., concurring); *United States* v. *Centennial Savings Bank*, 499 U.S. 573, 583-584 (1991).

Although the Fifth Circuit did not specifically address this separate issue in this case, the court of appeals necessarily rejected the government's contentions by affirming the Tax Court's judgment.[11] The Ninth Circuit, by contrast, *did* address this separate issue in affirming the Tax Court's *Downey* decision in *Schmitz* v. *Commissioner*

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[10] In 1989, Section 104(a)(2) was amended to provide that its exclusion "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2379. In *Burke*, this Court suggested that this amendment "allow[s]" the exclusion of punitive damages in physical injury cases after 1989. 112 S. Ct. at 1871 n.6. That question, however, was not presented in *Burke* and had not been addressed by the parties in that case. The Court's statements on that issue in *Burke* were therefore dicta. The proper interpretation of the 1989 amendment is also not at issue in the present case, which does not involve a physical injury and instead involves an unlawful discharge and an associated tax return which preceded the 1989 amendment.

[11] The Commissioner raised the separate issue of the excludability of liquidated damages for "willful violations" of the Act in the courts below. See Comm. C.A. Br. 27 n.15, 28 n.16; Comm. C.A. Reply Br. 16-17.

(App., *infra*, 85a-91a). In *Schmitz*, the Ninth Circuit concluded that, even though liquidated damages under the ADEA are awarded only for "willful violations" of the Act, such damages nonetheless serve the "compensatory purpose" of providing a remedy for "obscure and difficult to prove compensatory damages" (*ibid.*). The Ninth Circuit dismissed as "simply * * * a public policy matter" that liquidated damages under the ADEA are made available only to victims of "willful discrimination" (*ibid.*).

In our view, the conclusion expressly reached on this separate issue by the Ninth Circuit in *Schmitz* (and reached, *sub silentio*, by the Fifth Circuit in the present case) conflicts with the conclusion of the Fourth and Federal Circuits in *Commissioner* v. *Miller*, *supra*, and *Reese* v. *United States*, *supra*, that damages awarded to penalize a wrongdoer are not awarded "on account of personal injuries" within the meaning of Section 104 (a)(2).[12] Moreover, as Judge Trott noted concurring in

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[12] In *Commissioner* v. *Miller*, 914 F.2d at 591, however, the Fourth Circuit distinguished its conclusion in that case that punitive damages are not excludable under Section 104(a)(2) from its holdings in *Thompson* v. *Commissioner*, 866 F.2d 709 (1988), that liquidated damages under the Equal Pay Act *are* excludable on the ground that those liquidated damages serve, at least in part, a compensatory purpose. That analysis, which the Ninth Circuit also adopted in this case (App., *infra*, 89a), conflicts with the Seventh Circuit's decision in *Downey* v. *Commissioner*, *supra*, which concludes that liquidated damages awarded only on account of "willful violations" of the Act are not compensation for intangible injuries and are therefore not excludable (App., *infra*, 77a). Similarly, the Ninth Circuit's prior decision in *Criswell* v. *Western Airlines, Inc.*, 709 F.2d 544, 556 (1983), aff'd on other grounds, 472 U.S. 400 (1985), the Second Circuit's decision in *Reichman* v. *Bonsignore Brignati & Mazzota P.C.*, 818 F.2d 278, 282 (1987), and the Eleventh Circuit's decision in *Lindsey* v. *American Cast Iron Paper Co.*, 810 F.2d 1094, 1102 (1987), all conclude that liquidated damages under the ADEA are punitive rather than compensatory. See also *Trans World Airlines, Inc.* v. *Thurston*, 469 U.S. 111, 125-126 (1985).

the result in *Schmitz* (App., *infra*, 91a-92a), the Ninth Circuit's decision on this issue also conflicts with the Ninth Circuit's own prior decision in *Hawkins* v. *United States, supra*. See also App., *infra*, 92a-93a.

3. The recurring question presented in this case has substantial administrative importance. It affects countless individuals who have received, or will receive, monetary remedies under the ADEA and other state and federal statutory schemes. The proper income tax treatment of such statutory remedies also has important collateral consequences in damages litigation, where courts consider the taxability of the award in determining its proper amount. See *Purcell* v. *Seguin State Bank & Trust Co.*, 999 F.2d at 960-961.

In the absence of a decision from this Court resolving the conflict among the courts of appeal, the tax treatment of ADEA and other statutory awards will differ based solely upon geographic happenstance. Resolution of this recurring issue is needed to avoid continuing uncertainty and uneven application of the revenue laws.

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

DREW S. DAYS, III
*Solicitor General*

LORETTA C. ARGRETT
*Assistant Attorney General*

LAWRENCE G. WALLACE
*Deputy Solicitor General*

KENT L. JONES
*Assistant to the Solicitor General*

ANN B. DURNEY
EDWARD T. PERELMUTER
*Attorneys*

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No. 94-1041

Supreme Court, U.S.
FILED
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# In the Supreme Court of the United States

OCTOBER TERM, 1994

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JACK R. HAWKINS AND CYNTHIA HAWKINS, PETITIONERS

*v.*

UNITED STATES OF AMERICA

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES

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DREW S. DAYS, III
*Solicitor General*

LORETTA C. ARGRETT
*Assistant Attorney General*

KENNETH L. GREENE
EDWARD T. PERELMUTER
*Attorneys*

*Department of Justice*
*Washington, D.C. 20530*
*(202) 514-2217*

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## QUESTION PRESENTED

Whether punitive damages awarded in litigation under state law are excluded from gross income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries or sickness" (26 U.S.C. 104(a)(2)).

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# In the Supreme Court of the United States

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES

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### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-21a) is reported at 30 F.3d 1077. The opinion of the district court (Pet. App. 22a-23a) is reported at 93 U.S. Tax Cas. (CCH) ¶ 50,208.

### JURISDICTION

The judgment of the court of appeals (Pet. App. 24a) was entered on July 19, 1994. The petition for rehearing was denied on September 13, 1994 (Pet. App. 25a). The petition for a writ of certiorari was filed on December 9, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATEMENT

1. Petitioners insured an $8,000 automobile with Allstate Insurance Company (Allstate). The terms of the policy required Allstate to provide petitioners with a comparable vehicle in the event of an accident. Petitioner Cynthia Hawkins was involved in an accident in 1979 which rendered the insured automobile a total loss (Pet. App. 2a). Under their policy with Allstate, petitioners requested a replacement vehicle of equivalent value. Instead of providing such a vehicle, Allstate allegedly pressured petitioners into purchasing an inferior, less expensive automobile (*ibid.*).

Petitioners then filed suit in Arizona state court alleging that Allstate had breached a common law duty of good faith and fair dealing (Pet. App. 2a). The complaint requested (i) compensatory damages for Allstate's failure to provide the promised insurance benefits, (ii) compensatory damages for the mental and emotional distress that petitioners allegedly suffered and (iii) punitive damages in an amount appropriate to punish Allstate (*ibid.*).

The case was tried to a jury. The jury returned a verdict awarding $15,000 in compensatory damages and $3,500,000 in punitive damages to petitioners (Pet. App. 2a). The Arizona Supreme Court upheld the jury verdict. *Hawkins* v. *Allstate Insurance Co.*, 733 P.2d 1073, 1077-1078, cert. denied, 484 U.S. 874 (1987).

2. Petitioners initially reported the punitive damages award (net of attorneys' fees) as income on their 1988 federal income tax return. They subsequently filed an amended return to claim that the award of punitive damages was excludable from gross income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries

or sickness" (26 U.S.C. 104(a)(2)).[1] When the Internal Revenue Service denied the refund claim, petitioners commenced this suit in federal district court (Pet. App. 2a).

3. The district court granted petitioners' motion for summary judgment and ordered a refund of the taxes they had paid on the punitive damages award. The court held that the punitive damages award was excludable from gross income under Section 104(a)(2) as "damages received * * * on account of personal injuries" because "personal injuries were a requisite for the award of punitive damages in the underlying action" (Pet. App. 23a).

4. The court of appeals reversed (Pet. App. 1a-21a). The court followed the reasoning of *Commissioner* v. *Miller*, 914 F.2d 586 (4th Cir. 1990), and *Reese* v. *United States*, 24 F.3d 228 (Fed. Cir. 1994), in concluding that punitive damages are not excluded from income under Section 104(a)(2) as damages received "on account of personal injuries" (26 U.S.C. 104(a)(2)). The court held that punitive damages are not awarded "on account of personal injuries" but are instead "awarded 'on account of' the tortfeasor's egregious conduct" (Pet. App. 6a).

The court explained that the history and structure of Section 104(a)(2), as well as its plain language, reflect that this statute is designed to provide a tax-free recovery of amounts that merely compensate injured persons for the losses they have incurred from personal injuries (Pet. App. 11a, citing, *e.g.*, *Starrels* v.

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[1] Petitioners initially reported $2,937,406 on their 1988 return as income from their litigation with Allstate. This figure consisted of the punitive damages award net of attorneys' fees. When petitioners filed an amended return to exclude the punitive damages award, they sought a refund of $793,277 (Pet. App. 2a).

*Commissioner*, 304 F.2d 574, 576 (9th Cir. 1962)). Punitive damage awards, by contrast, represent a windfall gain to the tort plaintiff. They are designed to punish the tortfeasor, not to compensate the plaintiff (Pet. App. 12a). The court concluded that punitive damages awards do not come within either the express language or the evident purpose of the statutory exclusion from income provided by Section 104(a)(2) (Pet. App. 13a).

Judge Trott filed a dissenting opinion in which he concluded that the plain language of Section 104(a)(2) requires exclusion of punitive damages awarded in any personal injury case (Pet. App. 14a-21a). He reasoned that, so long as the underlying claim is based upon a personal injury, any damages recovered from that claim are excluded from income by the statute (Pet. App. 14a).

## ARGUMENT

1. The issue presented in this case has been addressed by the parties in the briefs filed in *Commissioner* v. *Schleier*, No. 94-500, which is scheduled for argument on March 27, 1995. In *Schleier*, the government contends that liquidated damages under the Age Discrimination in Employment Act of 1967—like punitive damages at common law—are awarded on account of the employer's willful misconduct, not "on account of personal injuries," and are therefore not excluded from income under Section 104(a)(2).[2] Because the Court's decision in *Schleier* may provide guidance for the proper disposition of the present case, it would be appropriate for the Court to hold this petition pending disposition of *Schleier*.

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[2] The government's brief in *Schleier* cites and relies on the decision of the Ninth Circuit in the present case, as well as the decisions of the Fourth and Federal Circuits in *Miller* and *Reese*. See 94-500 Pet. Br. at 26-34.

2. a. The application of Section 104(a)(2) to common law punitive damages awards may not be addressed by the Court in *Schleier*, for there is an independently sufficient basis on which the Court could dispose of that case. See 94-500 Pet. Br. at 26 n.16. If the Court does not reach the question whether liquidated and punitive damages are awarded "on account of personal injuries" in *Schleier*, we agree with petitioner that the petition in this case should then be granted.

In *Horton* v. *Commissioner*, 33 F.3d 625 (1994), the Sixth Circuit held that punitive damages received in a Kentucky personal injury suit are excludable from gross income. In so holding, the court expressly disagreed with the interpretation of Section 104(a)(2) adopted by the Fourth Circuit in *Commissioner* v. *Miller*, *supra*, the Federal Circuit in *Reese* v. *United States*, *supra*, and the Ninth Circuit in the present case. See 33 F.3d at 630 nn.9 & 11.[3] The Sixth Circuit further attempted to distinguish the facts of *Horton* from the present case on the theory that punitive damages in Kentucky (unlike punitive damages in Arizona) are awarded partly as compensation for the injury. See *id.* at 631-632. As petitioners observe (Pet. 11 n.9), however, the Sixth Circuit's effort in *Horton* to distinguish punitive damages awards as "punitive" or "compensatory" on a state-by-state basis is unconvincing. As Judge Kennedy noted in dissent in *Horton* (33 F.3d at 632):

> I do not think that Kentucky's explanation of why the concept of punitive damages should not be discarded makes punitive damages in Kentucky somehow different from other states. The primary purpose of

[3] The dissenting judge in *Horton* stated, by contrast, that she agreed with the reasoning and conclusion of the Ninth Circuit in the present case. 33 F.3d at 632 (Kennedy, C.J., dissenting).

punitive damages is to punish the defendant and thus deter such conduct.

In any event, the Sixth Circuit's express rejection in *Horton* of the reasoning of the Fourth, Ninth and Federal Circuits establishes a conflict among the courts of appeals without regard to whether punitive damages are characterized as "punitive" or as "in part serv[ing] a compensatory function" (33 F.3d at 631).

b. The proper application of Section 104(a)(2) to punitive damages awards is a recurring question of substantial administrative importance. This issue potentially arises every time a taxpayer receives a punitive damages award. Because punitive damages awards are often substantial, the proper treatment of such awards under Section 104(a)(2) often involves substantial tax obligations. Since the courts of appeals have disagreed in their interpretation of the statute, repetitive and wasteful litigation of this question is certain to occur absent an authoritative resolution by this Court.

We further agree with petitioners (Pet. 22) that the question presented in this case has continuing significance even after the amendment to Section 104(a)(2) that is effective for tax years after 1989. In 1989, the statute was amended to provide that its exclusion from income "shall not apply to any punitive damages [received] in connection with a case not involving physical injury or physical sickness." 26 U.S.C. 104(a) (Supp. V 1993). See Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, Tit. VII, § 7641(a), 103 Stat. 2379. In *United States* v. *Burke*, 112 S. Ct. 1867, 1871 n.6 (1992), the Court suggested that this amendment "allow[s] the exclusion of punitive damages [in] physical injury [cases]" after 1989. That question, however, was not presented in *Burke* and

had not been addressed by the parties in that case. The Court's statements on that issue in *Burke* were therefore dicta. Moreover, as we explained in our brief in *Schleier*, the amendment enacted by Congress in 1989 was designed to preclude application of the exclusion to punitive damages received in non-physical injury cases but was silent as to the taxation of punitive damages received in physical injury cases. See 94-500 Pet. Br. at 33-34 n.22.[4] With respect to the taxation of punitive damages awards in physical injury cases, Congress left the law as it existed *before* the 1989 amendment was enacted and made no attempt to declare how that law is to be applied. See *ibid.*; Douglas A. Kahn, *Taxation of Punitive Damages Obtained in a Personal Injury Claim*, 65 Tax Notes 487, 489-490 (1994). Resolution of the proper application of Section 104(a)(2) to punitive damages awards in the present case would thus be determinative for punitive damages awards in all physical injury cases both before or after 1989. It would also be determinative for such awards in non-physical injury cases before 1989, for the 1989 amendment resolves only the application of this statute to punitive damages awards in non-physical injury cases *after* 1989.

Because the proper application of Section 104(a)(2) to punitive damages awards represents a substantial recurring issue on which the courts of appeals have divided, the petition in this case should be granted if that issue is not resolved in the Court's decision in *Schleier*.

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[4] We have furnished a copy of our brief in *Schleier* to petitioners' counsel in this case.

## CONCLUSION

The petition for a writ of certiorari should be held pending this Court's disposition of *Commissioner* v. *Schleier*. In the event the issue presented in this case is not resolved in *Schleier*, the petition should be granted.

Respectfully submitted.

DREW S. DAYS, III
*Solicitor General*

LORETTA C. ARGRETT
*Assistant Attorney General*

KENNETH L. GREENE
EDWARD T. PERELMUTER
*Attorneys*

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IN THE
# Supreme Court of the United States
OCTOBER TERM, 1994

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JACK R. HAWKINS and CYNTHIA HAWKINS,
*Petitioners,*

v.

UNITED STATES OF AMERICA,
*Respondent.*

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

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## PETITIONERS' SUPPLEMENTAL BRIEF

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GREGORY R. SMITH
(Counsel of Record)
LAWRENCE M. STONE
ELLIOT BROWN
IRELL & MANELLA
1800 Avenue of the Stars
Suite 900
Los Angeles, CA 90067
(310) 277-1010

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

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## PETITIONERS' SUPPLEMENTAL BRIEF

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In the Brief for the United States filed with respect to the Petition for a Writ of Certiorari of Jack R. Hawkins and Cynthia Hawkins, the United States concludes:

> The petition for a writ of certiorari should be held pending this Court's disposition of *Commissioner v. Schleier*. In the event the issue presented in this case is not resolved in *Schleier*, the petition should be granted.

Resp. Br. at 4.

The United States thus concurs that the issue raised by the Hawkinses' petition is worthy of certiorari and requires resolution by this Court. The United States also concurs that this issue may be implicated by this Court's decision in *Commissioner v. Schleier*, No. 94-500, which is scheduled for oral argument on March 27, 1995.

Petitioners agree with the Government that, at a minimum, the petition herein should be held pending this Court's disposition of *Schleier*, and that if the issue presented in this case is not resolved in *Schleier*, the petition should be granted. But petitioners do not agree that holding this petition is preferable to granting it now.

In *Schleier*, this Court is presented with the issue of whether compensatory and liquidated damages awarded under the Age Discrimination in Employment Act of 1967, 29 U.S.C. 621 *et seq.* ("ADEA"), are excluded from gross income under section 104(a)(2) of the Internal Revenue Code as "damages received . . . on account of personal injuries." 26 U.S.C. § 104(a)(2). The United States contends that ADEA damages are not for "personal injuries" because they do not compensate for the traditional harms associated with personal injuries. As a fall-back, the Government argues that even if ADEA damages are for personal injuries, the liquidated damages portion of such damages is the same as punitive damages, and that the latter ought not to be considered "on account of" the underlying personal injury. The taxpayers in *Schleier* may prevail with respect to ADEA liquidated damages either by establishing that such damages are excluded from gross income because they are different from punitive damages or, alternatively, that to the extent that punitive damages and liquidated damages are similar, both are excluded.

It is thus accurate, as the Government notes at page 4 of its Brief, that the issue of whether punitive damages are "on account of personal injuries" has been briefed in *Schleier*. But this is primarily true for the Government, and not for the taxpayers. The taxpayers have primarily tried to draw a distinction between liquidated and punitive damages, arguing that the former are compensatory and that the latter are not, and that this distinction is relevant to whether the damages are excluded. When the taxpayers finally address the issue of whether punitive damages

ought also to be excluded, they do so with reluctance and in only the final three pages (at 39-42) of their brief.[1]

While the Government would prefer a decision in *Schleier* which holds that neither liquidated nor punitive damages are excluded from gross income, a decision which draws a distinction between those types of damages would also serve its interests: Inclusion of punitive damages in gross income is, to the Government, preferable to the exclusion of both punitive and ADEA liquidated damages. Moreover, the taxpayers in *Schleier* would not be adversely affected by a decision which draws a distinction between punitive damages and ADEA liquidated damages, permitting the exclusion from gross income of the latter but not the former.

In fairness to the taxpayers, such as the Hawkinses, who would be adversely affected by such a holding (or dicta) in *Schleier*, petitioners respectfully request that the issue of whether punitive damages are excluded from gross income not be decided absent briefing and argument by a party in whose interest it is to establish that punitive damages are "on account of personal injuries." [2]

There would be considerable benefit to deciding *Schleier* and *Hawkins* simultaneously. The only reason favoring the government's "wait and see" position is the fact that *Schleier* has now been fully briefed and set for oral argument.[3] But this need not deter this Court from granting

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[1] In introducing their abbreviated argument, the taxpayers state: "By attempting to style ADEA liquidated damages as exclusively punitive, petitioner is inviting the Court to resolve a question beyond the scope of Mr. Schleier's case, concerning which courts are in disagreement." Brief for Respondents Erich E. and Helen B. Schleier at 39.

[2] Unlike *Schleier*, the United States concedes in *Hawkins* that the underlying claim is for personal injuries.

[3] But for the Government's obtaining a thirty-day extension for the filing of its brief herein, the argument in *Schleier* would not

the petition in this case now. Oral argument in *Schleier* can be reset to permit briefing in this case and simultaneous oral argument. Alternatively, the decision in *Schleier* can be withheld pending briefing and oral argument in this case. Either of those options will help ensure that the issue raised in this case will not be decided by default, but will be squarely and fully addressed after briefing and argument by a party interested in advocating all of the reasons that punitive damages should be excluded under Section 104(a)(2).

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

GREGORY R. SMITH
(Counsel of Record)
LAWRENCE M. STONE
ELLIOT BROWN
IRELL & MANELLA
1800 Avenue of the Stars
Suite 900
Los Angeles, CA 90067
(310) 277-1010

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be so close in time to this Court's consideration of the Hawkinses' petition.